

# PRINCIPLES OF INDUSTRIAL ORGANISATION

AN ANALYSIS  
OF THE EVOLUTION AND NATURE OF BUSINESS  
ORGANISATION AND SUGGESTIONS FOR THE  
INDUSTRIAL DEVELOPMENT IN INDIA

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A. K. CHOWDHURY

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ALLAHABAD

TO  
MY MOTHER





## PREFACE

This book has been written primarily for the use of students preparing for the B.Com., M.A. (Econ.), and higher competitive examinations. It also contains useful information for the guidance of those who are interested in the organisation and efficient management of business concerns and in investments on sound lines.

In the course of my long experience as a teacher of Industrial Organisation, I have always felt the need of a suitable book on the subject, giving in a simple and self-contained form its broad outlines and essential principles. Previous writers, both Indian and foreign, have dealt with individual topics in an isolated manner and no attempt has yet been made by any other author to present the subject as a whole in a compact and well-arranged form with a view to suit the needs of our students in colleges and universities. In undertaking this task, therefore, I have throughout kept in view the special needs and difficulties of students and have attempted to present the theme in a simple and interesting form. To make the book really useful to the students and the public, I have tried to give a practical bias to it by incorporating in the subject-matter the results of my own observations and experience of business organisation, derived from my close association with many industrial concerns, both in India and America.

In these days when the country is looking forward to a wide expansion in the field of trade and industry, I feel that the general public should be acquainted with the sound principles of business organisation and management. There-

fore, I have also tried to cater to the needs of those who are interested or actually engaged in business by giving useful practical hints for their guidance. For instance, in the chapter on Industrial Planning, I have not only discussed in detail the methods of safeguarding the interest of investors in order that they may feel an impetus to increase their investments, but have also suggested the measures which should be adopted by the Government, industrialists and financiers for an all-round development of industries in India and for the promotion of companies which will be successful and financially sound. The section on Prospectus has been written from the point of view of both the promoter and the investor. It is necessary for the promoter to know how a prospectus should be written, and it is equally desirable that the investor should be equipped with sufficient knowledge so as to be able to examine and analyse it.

A book of this kind cannot obviously claim to be exhaustive; but I shall deem my labours amply recompensed if it is found useful by those for whom it is intended. I shall thankfully receive suggestions for its improvement.

Before bringing the preface to a close, I feel it my duty to express my deep sense of obligation to Mr. I. D. Varshnie, Managing Agent of the U.P. Glass Works, Ltd., Bahjoi, who first initiated me into the practical methods of business management. I am also greatly indebted to Professors Fisher, Dice and Ruggles of the Ohio State University, U.S.A., who taught me the theory of the subject. My best thanks are due to several managers and engineers of industrial concerns under whom I worked in America. I am deeply indebted to them all for helping me to learn many intricacies of trade and also for creating in me an interest in the organisation and management of business concerns.

I must also thank Mr. H. K. Ghosh, General Manager of the Indian Press, Limited, Allahabad, who in spite of acute shortage of paper very kindly undertook to print the book.

THE UNIVERSITY,

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## CHAPTER I

### INDIVIDUAL ENTREPRENEUR ORGANISATION

**Introduction.**—Whether a business is a manufacturing or a commercial concern, large or small, capital is required in every case. It is also necessary to organise, manage and control it. Of these two essential features of business, *viz.*, capital and control, the former is the more important because control usually follows capital. It is the capitalist who controls the business.

Capital may be supplied by a single individual, called a sole trader. He has the entire control of the business in his hands and this is called an “individual entrepreneur organisation” or individual ownership. Capital may also be supplied by two or more persons and the entire control may be in the hands of all of them. It is called a partnership organisation. Finally, capital may be supplied by several persons in the form of shares to a specially organised institute with a legal entity, called a joint-stock company or corporation. Historically, the joint-stock company is a partnership with transferable shares but such organisations are no longer in existence. At the present time no distinction is made between a joint-stock company and a corporation, as a matter of fact, they are all called joint-stock companies, though truly speaking, they are corporations. For our purpose, we shall call them, in this book, joint-stock companies. There are other forms which are merely outgrowths of these three.

An individual entrepreneur organisation or individual proprietorship is the earliest and simplest form of business organisation; even today it is the most prevalent.

**Advantages.**—Its advantages may be summed up under two heads: (1) facility of formation; and (2) effectiveness of motivation.

The small merchant likes to conduct his business in this form because it is easy and inexpensive to create, and because its organisation is very simple. One is not required to prepare a formal document and has not to pay any organisation fees or taxes to start a business of a sole-proprietorship. It is applicable to all kinds of business, for it involves the grant of no special power by the State and is open to private initiative. The minimum of time and trouble is involved in its formation. Any individual is free to engage in such a business at will, and if he finds that his undertaking is not sufficiently profitable, he may discontinue it or divert his capital to more profitable channels.

Because in this form of organisation the entire profit remains with the proprietor, the motivation is naturally great. The sole trader takes great personal interest in the business and this leads to economy and efficiency in the conduct of the concern. He, therefore, works very hard, supervises his employees effectively and tries to increase the efficiency of all so that the profit may be as high as possible.

Often business requires prompt and quick decision to avail of an opportunity or to meet a crisis. In this form of organisation the individual proprietor being the supreme judge of all matters pertaining to his business is not required to consult or take permission from others. He can, therefore, act with promptness and vigour which would not be possible in a more complicated organisation.



Again, this form of organisation enables the proprietor to preserve the trade secret. There being no group of stockholders who might be interested in other business, the owner can preserve trade secrets from his rivals.

A further advantage is that on account of unlimited liability the creditors are likely to be inclined to grant credit more liberally to individual proprietorship, than to a concern whose owner's liability is limited. This enables the owner to do business on a larger scale and thereby to increase his profit.

**Disadvantages.**—On the other hand, serious limitations attach to this form of organisation. It is not possible for one man to become expert in all the branches of business, and further, he cannot get sufficient time to supervise effectively and efficiently and control the work of all his employees. This naturally increases the cost of producing goods. Then again, the tackling of problems requires intelligence, experience, and good judgment which can be only limited in the case of one person as compared with two or more persons in a partnership or corporation. We have already discussed that individual proprietorship has the advantages of the directness of incentive and promptness of action and these are, to some extent, counterbalanced by the fact that one head may not be so good as two.

The amount of capital which can be collected together under individual proprietorship is decidedly limited. Very few people are rich enough to possess a large amount of money, and those, who are, are either not inclined to business, or not prepared to put all their money in one business on account of the risk involved. The larger the business the greater is the chance of increased profits as also of increased losses. This is doubly so because of the unlimited liability.

True, considerable amounts have been so applied in certain cases; but these are exceptions. It is not possible to raise so large a capital in the case of an individual proprietorship as it may be in the case of big joint-stock companies of today.

Another disadvantage is the unlimited liability of the individual proprietorship. It means that all the debts incurred by the business run against his entire property and not merely to the extent of the amount employed in the business. The larger the capital the greater is the risk of loss. It is, therefore, not possible for the individual proprietor to invest a large amount of money in his business, consequently, the business has to be on a small scale. From the standpoint of the owner this is certainly a disadvantage, but viewed from another point of view it is an advantage, because it enables him to get more credit and easily. The creditors are likely to be inclined to grant credit more liberally to the individual proprietorship than to a concern whose liability is limited. The reason is obvious; if the assets of the business itself are not sufficient to pay the debts, the creditor can realize the balance from all his other property.

**Social and Economic Points of View.**—We should study not only the advantages and disadvantages of each of the three types of business organisation but also their significance from social and economic points of view in order to determine the circumstances under which one form may be more useful than others to people and thus to society. This will enable the government of the country to adopt such a policy as may encourage people to organise and develop that particular type of business organisation which in the circumstances would be conducive to the well-being of society. It is, therefore, necessary, first, to find out how and in what

manner society is interested or affected by different forms of business organisation.

Let us suppose that there is only one general store in a locality where people make their daily purchases. If, for some reason, the store is closed, the consumers in and round about the locality are bound to be greatly inconvenienced; they will have to take the trouble of going to the market, to a distance of several miles, every time they have to make purchases of articles of daily use. Let us take another example, that of a manufacturing concern producing, say, glasswares. Its products will give satisfaction to the local consumers because they will be able to purchase them cheap and also be sure of the supply. It also creates a demand of the raw materials which it needs, gives employment to many skilled and unskilled workmen and also to managerial and other administrative staff. The factory also creates a demand, in the neighbouring villages, for straw crates and matting, and ropes for packing purposes, and these become a source of extra income to the village people, particularly to the women-folk. If after working for a few years the factory is closed, the consumers will lose because they will either have to go without the article or will have to purchase a similar one, probably at a higher price. Further, the closing of the factory will deprive the villagers of their extra income, and will throw out of employment all the skilled and unskilled men and other employees. When the factory is closed it will not require raw materials any more and will, therefore, not purchase them, consequently the demand of these commodities will fall. The fall in demand will affect the production of these commodities and the producers will be forced to produce less. This decrease in the production of the raw materials will not only increase

their cost of production and also throw some workmen out of employment, but also they (the producers) in their turn, will purchase less raw materials required by them. The closing down of one firm will affect the productivity and employment in other firms, and gradually it will affect a series of them in the chain of industries. The result will be inconvenience to the consumers and they will have to pay more than what they were paying before. But the worst of it all will be that men will be thrown out of employment. Society is primarily interested in the continued employment of its members so that they might be able to maintain their efficiency and usefulness. Society is also interested to see that its men should have facilities to purchase the best articles at the cheapest possible price. The hardships and difficulties of its members otherwise might make them inefficient, and increase their dissatisfaction to such an extent that ultimately it might lead to chaos in the very social structure which it is the imperative duty of every society to prevent. It is, therefore, clear that the continuity or permanence of any form of organisation must be considered in judging its utility to society.

It is, indeed, an up-hill task to make a business successful. One has to work very hard and struggle against adversities for the successful conduct of a business unit. One cannot, however, live for ever to guide its destiny and a time must always come when one has to hand over the management of the business to another. Usually, the principle upon which such a continuity largely depends is that of heredity and inheritance. But history shows and experience all over the world proves that the heirs usually lack the requisite qualifications and the business consequently falls into weak hands in the second or third generation. The reason is not far to seek. It is possible for a rich man to

give the best education which money can procure; but money alone cannot help to build character in a man and it is character, above all, that is necessary to run a business successfully. A successful business man is always busy in his daily work. He has no time personally to devote to the education of his children. He probably feels also that he is not competent to do it. He, therefore, engages the services of experts for this purpose, and with money he can have the best of them. But the most important aspect of education, *viz.*, the building of character which is essential to fit oneself for struggle in life, cannot always be acquired by money. Further, if one were brought up in luxury—as is usually the case with the children of all rich persons—and never knew what want is, one can never form a character to face and struggle against adversities with that coolness, patience, and determination which is vitally important for success in every walk of life, and particularly so in business where competition for the survival of the fittest is so keen. The personal association of the parent with his children from their very childhood can undo this mischief to a certain extent; it may enable him to sow in them the seed which would develop the necessary character to fit them for their struggle in life. This, however, is denied to them, for want of time, not only by the rich business men, but also, by all busy men in almost every profession and the result is that the son has to pay the penalty for the ignorance and folly of his rich father. It is a truism that the children of great men are usually below the average. It is true that the son of a business man has special advantages in getting the best training and learning the intricate problems personally from his father; besides, he gets the opportunity of starting his career with an established business. But the fact that he lacks the discipline and

stimulus of the earlier struggle makes him a failure. The result is that deterioration sets in and the business is dissolved in one or two generations. Sometimes it is kept going by infusing new blood.

We have already seen that in the individual entrepreneur organisation, the motivation being great, the productivity is greater and the benefit of this increased productivity is shared both by the proprietor and the consuming public. Moreover, unlimited liability gives adequate protection to the creditors. Therefore, the effective motivation and the facility of increased credit make much for social productivity. It has, however, limitation of capital which restricts the scale of production and the division of labour. Consequently, this form of business organisation cannot suit industries requiring large capital and increased division of labour. In conclusion, it can be said that this form will survive in a business, such as tailoring, which requires a small amount of capital, and where at the same time, the nature of the business is such that the customers have a preference for a shop where the master tailor himself is the proprietor and has time enough to give personal attention to the special needs and requirements of each customer. Finally, it is obvious that this form of business organisation teaches self-reliance, responsibility, and initiation and these qualities are of great social importance.

## CHAPTER II

### PARTNERSHIP

As enterprises grow larger, the method of individual proprietorship may become inadequate. The duties and responsibilities may become too arduous for a single individual, or the proprietor may desire to encourage valuable employees by a share in the profit. He may also wish to associate with himself men having capital, or special skill and knowledge. Therefore, for reasons of finance, personal liking or commercial gain, two or more persons may join together to do a business and agree between and among themselves to share both in the management of the business and the profits and losses resulting therefrom. Such a combination of traders is called a "partnership" and the persons forming it are called "partners." The business is known collectively as a "firm," and the name under which the business is carried on is called the "firm-name". A firm-name may be personal or impersonal, singular or plural, and need not contain the name of any existing partner.

**Definition.**—The broadest concept of partnership would make it include any association of individuals acting with a common purpose. In a more specific business sense "the partnership may be defined as the relation existing between persons competent to make contracts who agree to carry on a lawful business in common with a view to private gain". Such an organisation involves the combination of the property,

or skill, or both, of the members for the purpose of making profit, and the sharing of profits and losses in certain proportions.

The Indian Partnership Act, 1932, Section 4 defines partnership in the following terms:—

“Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.”

This definition has three elements;—

- (i) there must be an agreement entered into by all the persons concerned;
- (ii) the agreement must be to share the profits of a business; and
- (iii) the business must be carried on by all or any of the persons concerned, acting for all.

All these elements must be present before a group of associations can be held to be partners. The first element relates to the voluntary contractual nature of partnership; the second gives the motive which leads to the formation of firms, *i.e.*, the acquisition of gain; and the third shows that the persons of the group who conduct the business do so as agents for all the persons in the group, and are therefore liable to account for all.

In the definition it is said that only “persons” can form a partnership organisation. But the word “person” has not been defined in this Act. In the General Clauses Act the word “person” has been defined to include company, association and body of persons. It is often asked whether only legal persons may be partners in business, or firms and joint-stock companies also may enter into partnership. The decision of the High Courts in India has been that a firm



cannot be a partner in another firm as such.<sup>1</sup> In their opinion a firm is not a legal entity and as such cannot enter into partnership with other individuals, still there is nothing to prevent the individual members of a firm from being included in a larger partnership in another firm. All this is true of joint-stock companies as well. A joint Hindu family not being a legal person cannot be a partner in a firm; but any one member of a joint Hindu family either in his individual capacity or as representing the family may be a partner in a firm. "It is competent to the manager of a joint family business, acting on behalf of the family, to enter into a partnership with a stranger. But not all members of the joint family, but only such of its members as have in fact entered into partnership with the stranger, become partners. The manager, no doubt, is accountable to the family, but the partnership is exclusively one between the contracting members including the manager and the stranger. Such a partnership would be governed by the provisions of the Indian Partnership Act, 1932, with the result that if the manager died, the partnership would be dissolved on his death. The surviving members of the family cannot claim to continue as partners with the stranger, nor can they institute a suit for a dissolution of the partnership, their position being no higher than that of sub-partners. Nor can the stranger partner sue the surviving members as partners for the manager's share of the loss. His only remedy is to proceed against the manager's estate, if any. On a partition between the members of a joint family of which the manager is a partner with a stranger, the manager is bound to realize his share of the partnership assets for the benefit of the family, and for distribution among the members thereof. But this,

<sup>1</sup> *Law of Partnership* by Tirath Das Sehgal, p. 23.

it is conceived, he cannot do until the term of the partnership has expired.”<sup>2</sup>

### **Number of Partners in a Partnership Firm.—**

Partnership laws do not restrict the number of partners in a firm. In the Indian Partnership Act, 1932, there is no clause restricting the number of partners. Restriction there is, but by another Act. According to Section 4 of the Indian Companies Act, 1913, the number of members in a partnership cannot exceed 10 in case of banking business and 20 in case of any other business.

**The Business by Partnership must be for a Valid Object.**—The business carried on by a partnership must be for a valid object. Partnership being a relationship arising out of contract, is as such governed by the provision of Section 23 of the Contract Act, which lays down that if the object of the agreement is unlawful, or is forbidden by law, the agreement is void. So, if the business carried on by the partnership is unlawful, the partnership is illegal.

**Qualification of Partners.**—According to the old Act, it was necessary that persons to be partners must combine either capital, labour or skill; and a person who did not bring in any of these could not be a partner. According to the present Act (1932) it is not necessary that a partner should bring in either capital, labour or skill. Ordinarily, each partner contributes one or more of these, but it is no longer essential. There may be a *dormant* partner who puts in nothing.

**Illegal Partnerships.**—Partnerships are illegal in the following cases:—

1. When the number of persons entering into the

\* <sup>2</sup> *Principles of Hindu Law* by D. F. Mulla, p. 261. 1936.

partnership agreement exceeds 10 in the case of a banking concern and 20 in the case of other business.

2. When the object of partnership is unlawful, or is forbidden by law within the meaning of Section 23 of the Indian Contract Act.
3. When the partnership is formed with an alien enemy.

A partnership between a British subject and an alien is valid, but if he is an alien enemy, or one of the partners even if he is a British subject and is carrying on business in a country which subsequently wages war against India the partnership becomes void and illegal. Consequently, neither he nor his partner in India can recover money owing to the firm from a person residing within the jurisdiction of British Courts.”

4. Partnership is illegal if it is against international comity.

“Where a number of persons entered into a contract to carry out a scheme for equipping a steamship loading her with a cargo of whisky, sending her on a voyage across the Atlantic Ocean and selling the whisky either in the United States of America, or outside the borders of that country to some person or persons who had facilities for disposing of the whisky within the United States, in breach of the prohibition laws of that country, held (Scruton L. J. dissenting), that the contract was void as against public policy as it had been formed to commit or instigate or procure others to commit an act which was criminal by the law of the United States,

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<sup>3</sup> Halsbury: *Laws of England*, Vol. 22, p. 19.

and therefore all proceedings in respect thereof must be dismissed without costs."<sup>4</sup>

**Suit by an Illegal Partnership.**—An illegal partnership cannot maintain an action in respect of any transaction tainted with illegality. For instance, if it is formed for smuggling goods it cannot sue for the price of such goods sold. One partner cannot maintain a suit for the accounts of an illegal partnership. But an illegal partnership can prosecute a man for stealing goods or a member for embezzling funds.

The illegality of the partnership is of course no reason why it should not be sued. So long as the transaction entered into by a person with the firm is not illegal, or he himself is not implicated in the illegal act in any way, he has the right to sue and the fact that the person with whom he is dealing is illegally associated in partnership cannot defeat his case.

**Co-ownership and Partnership.**—It is important to understand clearly the difference between co-ownership and partnership. In a partnership two or more persons must join together to carry on a business. The conduct of business is essential to make a combination of persons a partnership. The joint ownership alone does not make them partners. Even if the common property owned jointly by persons yields a return and the return is divided according to their respective interests, it would not make them partners. For example, if A and B, the two co-owners of a house, let it out on rent, it would not make them partners, either as to the house or as to the rent. Their shares in the house are distinct, independent and separately alienable. If they used

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<sup>4</sup> *Law of Partnership* by Tirath Das Sehgal, p. 31.

the house as a hotel, managed it themselves or through their agent for a common profit, they would be partners in the business of hotel-keeping. Persons may even acquire property in common in order to make profit out of it without creating a partnership. It is thus clear that neither common interest nor sharing of profits will make a partnership unless there is really a common business. Sharing the profits of an undertaking does not of itself constitute a partnership, though the existence of partnership may often be inferred from it. The true test of a partnership is not whether a man receives a share of profits, but whether a business is being carried on by him along with another or others as principals. This then is the chief point of difference between co-ownership and partnership. The other points of difference as given by Lindley are the following:—

1. Co-ownership is not necessarily the result of an agreement. Partnership must arise out of an agreement.
2. Co-ownership does not necessarily involve community of profit or loss, but partnership does.
3. One co-owner can transfer his rights and interest to a stranger without the consent of the other co-owners; but one partner cannot transfer his rights to strangers without the consent of the other partners.
4. One co-owner is not the agent of the other co-owners; but every partner is an agent of the other partners.
5. A co-owner has no lien for general outlays and expenses; but a partner being an agent of the

other partners, has a lien on the partnership properties.

6. A co-owner has a right of division in specie. No partner can seek division of the partnership properties in specie. His only right is to have a share of the profits out of the sale-proceeds of property.
7. Co-ownership does not necessarily exist for gain, but a partnership does.

### **Characteristics of a Partnership.—**

1. It is a contractual relationship and does not require a franchise or special sanction of the State. A partnership being the result of an agreement between and among the partners, they can change the nature of business, or even can dissolve it at any time by mutual consent. (Sec. 5.)

2. Each partner usually contributes a sum of money termed "capital" to the common fund. The amount of contributions by each partner may or may not be equal. Often one or more of the partners contribute, in lieu of capital, expert knowledge of the business for which the partnership is formed. Since the passing of the Indian Partnership Act, 1932, one can become a partner without contributing capital, labour or skill.<sup>5</sup> All the same, the usual practice is to contribute capital. (Sec. 4.)

3. Each partner shares the profit, as also the loss, resulting from the business undertaking either equally, or in the proportion of capital contribution or in any agreed proportion. Sometimes, in addition to a share in the profits, one or all of the partners receive a salary for actively taking part in the management of the business. (Sec. 6.)

<sup>5</sup> *Law of Partnership* by Tirath Das Sehgal, p. 29.

4. Unless otherwise agreed upon each partner has an inherent right to take part in the management of the business. (Sec. 12).

5. The partnership and the members who compose it are not legally distinct. The law in general regards the "partners" and the "partnership" as one, and, in theory, does not recognise the separate existence of the partnership. It follows, that each partner is an agent<sup>6</sup> of the firm and can make contracts binding<sup>7</sup> on the partnership and the other partners, even if a partner acted without authority, provided he acts within the ordinary course of the firm's business. But if the contract is outside the ordinary business of the firm and without authority he does not bind the firm. For instance, a partner in a cotton textile business who ordered sugar without authority would not bind the firm but if he accepted a bill of exchange for a supply of cotton yarn he would.

6. The partnership is dissolved by the death or legal incapacity of any one of the members unless otherwise agreed upon. (Sec. 42.)

7. Only individual persons can become partners and not firms or associations. (Sec. 4.)

8. One cannot sell one's partnership rights to a third party without the consent of all the partners. He can sell to co-partners only. It is, therefore, difficult to withdraw from partnership without loss. (Sec. 31.)

9. The interest of the minority is sufficiently safeguarded in a partnership business because a majority cannot drive away any partner. In a partnership at will any one

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<sup>6</sup> Section 18, Indian Partnership Act, 1932.

<sup>7</sup> Section 19, Indian Partnership Act, 1932.

partner can dissolve the firm. A dissolution means loss to every one. The fear of dissolution makes the majority considerate of the wishes and sentiments of the minority. (Sec. 40.)

10. According to Section 4 of the Indian Companies Act, 1913, it is illegal to have more than 10 partners in a banking business and more than 20 in any other business.

11. In an ordinary partnership each partner is personally liable for the whole of the debts of the firm. This is called unlimited liability. In India a partner's liability is joint and several with all the partners. In England it is joint liability only. (Sec. 25.)

**Difference between a Joint and Several Liability. —**

In the case of a "joint liability" if a firm fails to pay the creditor, he should sue the whole firm and not one member alone. It is not that he is not permitted to sue a partner; but, in case the property of the partner sued is not sufficient to meet the dues of the creditor, he is prevented from suing any other partner for the balance. On the other hand, if the suit is filed against the firm, it automatically means a decree against all the partners. If one partner's property is not enough the balance can be realised from the property of the other partners. In the case of "several liability" the law does not prevent a creditor suing one partner at a time till the whole amount is realised. It must be clearly understood that in both the cases, that is, whether the liability is joint or several, each partner has an unlimited liability irrespective of his capital contribution, and the difference is only in procedure. In actual practice, however, the suit is usually brought against the firm, irrespective of the liability being joint or several.

**Deed of Partnership.**—A partnership may be agreed upon verbally or be implied from the conduct of the business



or may be in writing. The difficulty of a verbal agreement is the necessity to prove and to show that such and such conditions were agreed upon. It is, therefore, best to have a written agreement. The document in which the respective rights and duties of the members of a partnership are set forth is called a Deed of Partnership. It is signed by all the partners.

A properly drawn-up deed of partnership should clearly state the arrangements agreed upon with regard to the following:—

1. The term or duration of partnership, that is, the period for which the partnership is formed.
2. The amount of capital each partner undertakes to subscribe and the manner of its contribution.
3. The usual practice is to calculate profits earned by the firm at the end of each financial year. In the meantime and in anticipation of profits, should partners be allowed to draw money from time to time for their personal expenses? If so, the total amount up to which one may be permitted to take.
4. The rate of interest, if any, to be charged on such drawings and allowed on loans by the partners or on capital subscribed by the partners.
5. The division of work among the partners, that is, the work for which each partner should be responsible for the efficient conduct of the business.

6. The proportion in which profits and losses are to be shared by the partners.
7. The conditions on which new partners may be taken and old partners might be permitted to retire.
8. The principle on which "goodwill" is to be calculated on the retirement or death of a partner.
9. The amount of salary, if any, that may be agreed upon to be paid to each partner by the firm.
10. The agreement to maintain proper books of accounts and to prepare a profit and loss account at the end of each fiscal year.
11. The right of a partner to get the books of accounts independently examined by an expert of his choice.
12. The partnership deed also usually contains an "arbitration clause" which enjoins upon all partners to refer a dispute, if any, to an arbitrator and abide by his decision.


**Kinds of Partners.**—Partners who take an active part in the management of the business are called *Active Partners*. Those who do not take any active part in the conduct of the business are known as *Sleeping or Dormant Partners*; they are equally responsible with the Active Partners for the debts of the partnership. A person who lends his name and credit to a firm in such a way as to lead those trading with the firm to believe that he is a partner in it, though in reality he is not a partner and has no interest in the firm, yet, holds himself responsible as a partner in that firm to those persons who on the faith of such representation gave credit to the firm.

Such a person is known as an *Ostensible* or *Nominal Partner*, and according to Section 28 of the Indian Partnership Act, 1932, such a representation is known as "Holding Out," and the liability which arises out of it is neither more nor less than a special application of the principle of estoppel as contained in Section 115 of the Indian Evidence Act. A person may become liable by estoppel although he contributes neither capital nor skill and has no interest in the profits, or is indemnified against all possibility of loss or is a mere servant of the firm. A servant of the firm may become liable to third persons as a partner if he so acts in the business as to represent himself as a partner in the firm and the creditor gives credit to the firm on his thus representing himself.

**Duration of Partnership.**—A partnership may be for an indefinite period. It is then called a *partnership-at-will*. It can be dissolved by any partner at any time by giving a notice in writing to that effect to the other partners. A partnership may also be arranged for a fixed time, or for a particular venture, or undertaking, and is called *particular partnership*. Such a partnership automatically dissolves after the expiry of the period, or after the work is over for which the partnership is formed. It can be dissolved before the period or before the completion of the job when all the partners agree to do so. Even if one of the partners disagrees, the firm cannot be dissolved.

But if a firm continues to carry on business after the expiry of the term for which it was originally constituted, the mutual rights and duties of the partners remain what they were before the expiry, so far as consistent with the incidents of partnership-at-will. Similarly, if a firm constituted to carry on one or more adventures or undertakings carries on

others, the mutual rights and duties of the partners in respect of these others are the same as those in respect of the original adventures or undertakings.

**General Duties of Partners**  Partners are bound to carry on the business of the firm to the greatest common advantage, to be just and faithful to each other, and to render true accounts and full information of all things affecting the firm to any partner or his legal representative. (Sec. 9.)

A partner is generally liable to the firm for loss caused to it by his wilful neglect in the conduct of the business, though he can get himself exempted from such a liability by a contract between the partners; but under no circumstances can he contract himself out of liability for fraud. (Sec. 10.)

**Mutual Rights, Duties and Liabilities of Partners.**—The rights and liabilities of partners are governed by Sections 12 and 13 of the Indian Partnership Act, 1932, wherein it is laid down that unless there is a provision to the contrary in the partnership-deed, the following rules shall hold good:—

1. Every partner irrespective of the amount of capital contribution has an inherent right to take part in the management of the business.
2. Every partner is bound to attend diligently to his duties in the conduct of the business.
3. Any difference arising as to ordinary matters connected with the business may be decided by a majority of the partners, and every partner shall have the right to express his opinion before the matter is decided, but no

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*Note.*—Serial numbers 1—4. Section 12, Indian Partnership Act, 1932.

change may be made in the nature of the business without the consent of all the partners.

- ✓ 4. Every partner has a right to have access to and to inspect and to copy any of the books of the firm.
- ✓ 5. A partner is not entitled to receive remuneration for taking part in the conduct of the business.
- ✓ 6. The partners are entitled to share equally in the profits earned, and shall contribute equally to the losses sustained by the firm.
- ✓ 7. Where a partner is entitled to interest on the capital subscribed by him, such interest shall be payable only out of profits.
- ✓ 8. A partner making, for the purposes of the business, any payment or advance beyond the amount of capital he has agreed to subscribe, is entitled to interest thereon at the rate of six per cent per annum. It is five per cent in England.
9. The firm shall indemnify a partner in respect of payments made and liabilities incurred by him:
  - (a) in the ordinary and proper conduct of the business, and
  - (b) in doing such act, in an emergency, for the purpose of protecting the firm from

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*Note.*—Serial numbers 5—10. Section 13, Indian Partnership Act, 1932.

loss, as would be done by a person of ordinary prudence, in his own case, under similar circumstances.

10. A partner shall indemnify the firm for any loss caused to it by his wilful neglect in the conduct of the business of the firm.
11. No person can be introduced as a partner into the firm without the consent of all the partners. (Sec. 31.)
12. If a partner derives any profit for himself from any use of the property or business connection of the firm or the firm-name, he shall account for that profit and pay it back to the firm. (Sec. 16.)
13. A partner is a joint owner of partnership property, but he has no right to ask for a share in any particular property. He can have only the business wound up.<sup>8</sup>
14. Partnership property cannot be pledged as security for the private debts of a partner.
15. The property of a partnership firm shall be held and used by the partners exclusively for the purpose of the business.

**Undivided Hindu Family Business.**—Where a joint family takes to trading and the trade is handed down from the previous generation, it is called trading family and the trade is known as family trade. An ancestral business is one

*Note.*—Serial numbers 14 and 15. Section 15, Indian Partnership Act, 1932.

<sup>8</sup> Section 48. Indian Partnership Act, 1932; and *in fra*, p. 40.

which is handed down from the preceding generation. A business started by the father is ancestral in the hands of the sons.

According to Hindu Law, a person born in the family becomes a partner in the ancestral business as a matter of course and does not stand in need of obtaining the consent of the other members of the family. That is why it is said that the relation of members of joint Hindu trading family is the result of status and does not arise from contract. An ancestral business, as explained above, carried on by a joint Hindu family is governed by Hindu Law. This does not mean that a new business started by brothers, or cousins, or uncle and nephew, who are members of the joint family is an ancestral business. Such a business is the result of contract and is not governed by the rules of Hindu Law: it will be governed by the Indian Partnership Act, 1932, consequently Section 4 of the Indian Companies Act will be applicable to it.

Similarly, where a manager of a joint Hindu family enters into a partnership with a third person, he alone is the partner and other members of the family are not partners in the firm. The manager may, however, enter into a partnership with a third person in a representative capacity so as to make all the family members partners. It must be clearly understood that two joint Hindu families cannot enter into partnership as such; but a partnership business can be formed between persons each of whom is a member of a joint family.

#### **Difference between "Hindu Undivided Family" Business and an Ordinary Partnership.—**

1. In an ordinary partnership a female can be a partner but she cannot be a coparcener, and therefore cannot

be a partner in a joint family trade. A Hindu coparcenary is a much narrower body than the joint family. It includes only those persons who acquire by birth an interest in the joint or coparcenary property. These are the sons, grandsons and great-grandsons of the holder of the joint property for the time being, in other words, the three generations next to the holder in unbroken male descent. (Section 213 Hindu Law.) No female can be a coparcener under the Mitakshara Law. Even a wife, though she is entitled to maintenance out of her husband's property and has to that extent an interest in his property, is not her husband's coparcener. Nor is a mother a coparcener with her sons.\* (Section 217, Hindu Law.)

2. In an ordinary partnership, all the partners are liable personally for the obligation of the firm, but in a Hindu joint family firm only working partners are personally liable and others are liable only to the extent of their shares in the family property.

3. In a joint family firm, the manager and possibly other working partners can contract debts and pledge property, but in an ordinary partnership any partner can do so.

4. The members of a joint family are not entitled to claim any separate share of profits until partition. In an ordinary partnership, however, each partner is entitled to his profits.

5. A member of a joint family on dissolution is not

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\* *Note*.—Since 1937 a widow has been given an equal right along with her sons in the property of her husband and also the same right of claiming partition as a male owner has. She has, however, been given a limited interest only, which means that she will have no right to sell or dispose of the property in any way she likes, and after her death it will devolve upon her son or sons or legal heirs.



entitled to ask for an account of the past period, while in an ordinary partnership a partner can do so.

6. None of the rights and obligations as are laid down in Section 12 of the Partnership Act, 1932, appertain to members of the joint Hindu family, that own family business.

7. In the case of an ordinary partnership notice of dissolution which must be in writing is necessary in order that the retiring partner may not be liable thereafter to old customers. In a joint family trading business, no such notice is necessary except in the case of a coparcener taking active part in the business.

8. Any partner may in an ordinary partnership, during the course of business, bind other partners except in a few cases in which he has no implied authority. In a joint family business, it is the manager alone, unless special arrangement exists, who can take part in business and bind other coparceners.

9. Ordinary partnership is dissolved by the death of a partner unless there is an agreement to the contrary. Joint family trading business cannot be dissolved on the death of one of the copartners.

## RELATION OF PARTNERS TO THIRD PARTIES

**1. Implied Authority of Partners.**—Every partner has an implied authority to bind the firm, provided he acts in the usual course of the business as is carried on by the firm.<sup>9</sup> A partner who acts for the business of the firm is an agent of

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<sup>9</sup> Indian Partnership Act, 1932, Section 19.

the firm,<sup>10</sup> as such, his action is binding on the firm. This is called the "implied authority" of the partners. Ordinarily, a partner is not an agent of another partner in the sense, that two partners cannot stand to each other in the relation of principal and agent. But it is possible for one partner to be an agent of another in respect of dealings with third persons in connection with the business of the firm.

Although a partner is an agent of the firm, the converse is not true, that is, the firm is not presumed to be an agent of the individual partners. Payment to one partner is, in general, a valid payment to the firm; but payment to the firm of a private debt due to one partner is not a discharge unless it is shown that the firm had in fact authority to receive it.

But there are certain limitations or restrictions on the implied authority of partners. One partner even though acting for and in the name of the firm cannot validly appoint an agent to act for and sue on behalf of the firm. A partner cannot delegate his authority without the consent of all. He has no authority to compromise or withdraw a claim; but he has authority to bring or defend a suit brought against the firm in relation to the partnership business. A partner cannot enter into partnership with third persons on behalf of his firm, as it cannot be said that in doing so, a partner acts in the usual course of business.

The partners in a firm may, by contract between them, extend or restrict the implied authority of any partner. Notwithstanding any such restriction, any act done by a partner on behalf of the firm which falls within his implied authority binds the firm, unless the person with whom he is dealing

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• <sup>10</sup> Indian Partnership Act, 1932, Section 18.

knows of the restriction of "implied authority" or does not know or believe that partner to be a partner. But in no circumstances can they restrict their liability which must always remain unlimited. There is no limited partnership known to Indian law. They can restrict the implied authority of the partners but not their liability.

In the absence of any usage, or custom of trade to the contrary, the "implied authority" of a partner does not empower him to:—

- (a) submit a dispute relating to the business of the firm, to arbitration,
- (b) open a banking account on behalf of the firm in his own name,
- (c) compromise or relinquish any claim or portion of a claim by the firm,
- (d) withdraw a suit or proceeding filed on behalf of the firm,
- (e) admit any liability in a suit or proceeding against the firm,
- (f) acquire immovable property on behalf of the firm,
- (g) transfer immovable property belonging to the firm, or
- (h) enter into partnership on behalf of the firm.

**2. Partner's Authority in an Emergency.**—A partner has authority, in an emergency, to do all such acts for the purpose of protecting the firm from loss as would be done by a person of ordinary prudence, in his own case, acting under similar circumstances, and such acts bind the firm. This emergency power is enjoyed by the partners even when

the act done is not in the usual course of business. (Sec. 21.)

**3. Unlimited Liability of Partners.**—Every partner is liable, jointly with all the other partners and also severally, for all acts of the firm done, while he is a partner. In other words, each partner is personally liable for the whole of the debts of the firm. (Sec. 25.) This is called unlimited liability. In England the liability of a partner is joint only.

**4. Liability of Firm for Misapplication by Partners.**—The firm is liable to make good the loss to the third party, if a partner, acting within his apparent authority, receives money or property from a third party and misapplies it. The firm is also liable if in the course of its business it receives money or property from a third party, and the money or property is misapplied by one of the partners, while it is in the custody of the firm. (Sec. 27.)

In the first case the same partner receives money and misapplies it. In the second case the property is received by one and thereafter when the property has passed into the custody of the firm, is misapplied by any other partner. The firm will be equally responsible even when the money has been received by a clerk or agent of the firm, and after it has passed into the custody of the firm one of the partners misappropriates it.

**5. Holding Out.**—If a person lends his name and credit to a firm in such a way as to lead those trading with the firm to believe that he is a partner in it, though in reality he is not and has no interest in the firm, yet holds himself responsible as a partner in that firm to those persons who on the faith of such representation gave credit to the firm. Such

a representation is known as "Holding Out," and the person is liable to such a creditor, or creditors as the case may be, in the same way and to the same extent as other partners are. (Sec. 28.)

#### **6. Rights of Transferee of a Partner's Interest.—**

If one partner assigns his share to an outsider without the consent of his co-partners during an existing partnership, no immediate rights accrue to an assignee against other partners, such an assignee only having a right against his assignor. The assignment does not give the assignee a right to claim accounts or to sue for dissolution. He has no right to interfere in the management of the business. It is only when dissolution occurs that the right of the assignee arises to take action in the same way as an assignor would have done, to demand an account as from dissolution. (Sec. 29.)

The position of an assignee is not that of a partner in the firm. The assignor remains the partner and the assignee is only entitled to receive the share of profits due to the assignor. A transferee can become a partner in place of the transferor if the other partners agree to take him in. It is also possible that there may be an agreement between the partners to the effect that the transferee shall become a partner and in such a case the transferee will become a partner.

The transferee is not liable to the creditors of the firm. Even if the assignee of a share is admitted in partnership he is not liable for the debts of the firm as originally constituted, although he may have entered into an agreement with his assignor to become liable for the past debts of the firm. A creditor cannot claim against the transferee, for he is no party to the contract entered into between the transferee and the assignor. The assignor alone is liable

for losses but an assignee sharing in profits must indemnify his assignor against losses. The transferee is not bound by the arbitration clause in the partnership-deed unless he consents to be so bound. The assignment does not cause the immediate dissolution of the firm. It, however, gives the partner other than the partner transferring, a right to bring a suit for dissolution provided the transfer is in respect of the whole of the interest of the partner. (Sec. 44.) In the absence of a contract, one partner cannot object to another partner transferring his share.

**7. Position of a Minor in a Partnership.**—As partnership is the creation of a contract and as a minor is incapable of entering into a valid contract, a minor cannot, therefore, be a partner in a firm. But he can be made very nearly a partner if the partners agree among themselves to admit the minor to the benefits of the partnership. If this is done, the minor will get his share of the property and of the profits of the firm as may have been agreed upon between the partners; he may also have access to and inspect and copy any of the accounts of the firm. But during his minority he cannot sue the partners for his share of the property or of the profits, nor can he demand an account, and of course he cannot have any right to take any part in the conduct of the business. Only if while a minor, he wishes to cut off his connection with the firm he can sue for an account and for his share of the property and profit. Such a minor is not personally liable for any liabilities of the firm incurred during his minority; his assets and share of profit in the firm are, however, liable, that is, his liability is limited. (Sec. 30.)

When he attains majority he has an option of becoming a full partner or of not becoming a partner; this choice he must exercise within six months of becoming a major, or

within six months of his coming to know that he had been admitted to the benefits of the partnership whichever date is later. Unless he gives a public notice within either of these periods that he does not elect to be a partner it will be taken that he has become a partner.

When a minor comes of age and elects to become a partner, the consent of the other partners is not necessary to enable him to be a partner. Although an incoming partner is not liable for the debts of the firm incurred before he becomes a partner, a minor who becomes a partner (on attaining majority), becomes liable for all the debts incurred since he was admitted to the benefits of partnership. This is so because he has benefited by them.

Under the English law, there is nothing to preclude an infant from entering into a contract of partnership, though, speaking generally, while he is an infant, he incurs no liability and is not responsible for the debts of the firm, and when he comes of age, or even before, he may disaffirm past transactions. In effect there is not much difference between the English law and the Indian law, but the initial principles are different.

#### INCOMING AND OUTGOING PARTNERS

**Incoming.**—Subject to contracts among partners no person shall be introduced as a partner in a firm without the consent of all the existing partners. (Sec. 31.) However, the partners might agree that a senior or principal member of a firm shall have the right to nominate one or more new partners, named or not named, under agreed conditions. Such an agreement will be binding on the partners even though when the time comes one or more of the partners may be unwilling to accept the new partner.

A new partner in a firm does not, however, become liable for any act of the firm done before he became a partner, but is liable for new debts arising out of a continuing contract made by the firm before he joined it.

**Retirement of a Partner.**—A partner is said to retire when the surviving partners continue to carry on the business of the firm, and the member retiring ceases to be a partner. That is to say a partner is said to retire when the firm is not dissolved by his ceasing to be a partner. (Sec. 32.)

**The Method of Retirement.**—In case of partnership other than partnership-at-will a partner may retire with the consent of all the partners. He may retire without their consent if there is an agreement in the partnership-deed giving a partner the right to retire. In the case of partnership-at-will a partner may retire without the consent of other partners by giving a notice in writing to all the other partners. Such a withdrawal enables the remaining partners to continue the business without dissolving the firm.

**The Liability of a Retiring Partner.**—A retiring partner can free himself from the debts of the firm incurred before his retirement by an agreement between the partners and the creditors discharging the outgoing partner from all liabilities. The remaining partners alone cannot give this freedom to the retiring partner. He can be exempted only if the creditors agree. The surviving partners cannot even indemnify him from all such debts. Such an agreement only gives the retiring partner rights against the surviving partners and does not avail him against creditors, for there is no privity of contract between him and the creditors. However, if the creditors accept the security of the continuing partners, the retiring partner is discharged.

**Expulsion of a Partner.**—Ordinarily the majority of



partners has no right to expel a partner. A partner may be expelled by the majority only if the contract between the partners gives authority to the majority to expel a partner and if such authority is exercised *bona fide*, that is, with an honest view to the interest of the firm. (Sec. 33.) The majority must be of the members of the firm and not of shares held by the members. The partner sought to be expelled should be served with a notice containing the charges. The expulsion of a partner does not dissolve the firm; it continues with the remaining partners.

If a partner is expelled without powers or *mala fide* it is void and the remedy for the aggrieved partner, is to sue for reinstatement, but he cannot sue for damages. Such a partner cannot be restrained from carrying on the business on his own account. He can even solicit the old customers of the firm.

**Insolvency of a Partner.**—A firm is dissolved on the adjudication of a partner as insolvent unless there is contract to the contrary. Whether a firm is dissolved or not the adjudicated partner at once ceases to be a partner, and his estate is not liable for any act of the firm done after the date of adjudication. (Sec. 34.) The same rule is applicable in the case of the death of a partner, that is, if the firm is not dissolved by the death of a partner because of a contract between the partners to that effect, the estate of a deceased partner is not liable for any act of the firm done after his death. No notice of death is necessary to determine the liability of the estate of the deceased. (Sec. 35.)

**Rights of Outgoing Partners to carry on Competing Business.**—When a partner goes out of the firm, certain restrictions are imposed on him in the matter of opening a competitive business. Some of these restrictions are imposed

by the law itself; further restrictions may be imposed by a contract between the outgoing partner and the remaining partners. The restrictions imposed by the law itself are the following:—

1. He must not use the name of the firm.
2. He must not represent himself to the public as carrying on the business of the old firm, *e.g.*, as a branch of it or otherwise.
3. He must not canvass and solicit orders from the previous customers of the firm. If any of them, of their own accord, without being requested by him begin to deal with him, then that is no fault of his.

Some of these restrictions, however, may be removed if there be a contract to that effect. Further restrictions may be imposed by a contract that he may be prohibited from carrying on any similar business within a specified period of time, or a specified area, or locality, and such contract will be valid if the restrictions of time or area are reasonable. (Sec. 36.)

**Dissolution of a Firm.**—Section 39 of the Indian Partnership Act, 1932, lays down that a firm is not said to be dissolved by the fact of one or more members ceasing to be partners in it while others remain. It is only when all and every one of the members of the firm cease to carry on its business in partnership and none of them stand to any other in the relation of a partner that a firm can be said to have been dissolved. The going out or the coming in of a partner does not operate as a dissolution of the firm because there is no dissolution between all the partners. A change in the firm affected by retirement, expulsion or insolvency of

a partner does not destroy the personality attached to the firm; dissolution, however, completely destroys such a personality.

#### CAUSES OR METHOD OF DISSOLUTION

**1. Dissolution by Agreement (Sec. 40).—**A firm may be dissolved with the consent of all the partners or in accordance with a contract between the partners. The majority cannot dissolve the partnership against the wishes of the minority.

**2. Compulsory Dissolution or Dissolution by the Operation of Law (Sec. 41).—**A firm is dissolved—

- (a) by the insolvency of all the partners or of all the partners but one, or
- (b) by the happening of any event which makes it unlawful for the business of the firm to be carried on, or for the partners to carry it on in partnership. For example, when war is declared and some of the partners of a firm thereby become alien enemies, it becomes unlawful to carry on the business in partnership, and the firm is not only dissolved but the partners cannot maintain a suit against third parties. Again, if at any time the number of partners increases to more than 10 in a banking business and to more than 20 in business other than banking, the firm must be incorporated according to the Indian Companies Act, and as such its continuance as a partnership is illegal.

**3. Automatic Dissolution or Dissolution on the Happening of Certain Contingencies (Sec. 42).**—A firm is dissolved by the death or insolvency of a partner, the expiry of the term of partnership, or the completion of a venture unless there is a contract to the contrary.

**4. Dissolution by Notice of Partnership-at-will (Sec. 43).**—Where the partnership is at will, the firm may be dissolved by any partner giving notice in writing to all the other partners of his intention to dissolve the firm.

A notice once given cannot be withdrawn without the consent of those to whom it is given, for the notice puts an end to the partnership and the partner giving notice cannot become a partner with others again without their consent.

**5. Dissolution by the Court or Judicial Dissolution (Sec. 44).**—At the suit of a partner, the Court may dissolve a firm on any of the following grounds, namely:—

- (a) that a partner has become of unsound mind, in which case the suit may be brought as well by the next-friend of the partner who has become of unsound mind as by any other partner;
- (b) that a partner, other than the partner suing, has become in any way permanently incapable of performing his duties as partner;
- (c) that a partner, other than the partner suing, is guilty of misconduct towards a third party which is likely to affect prejudicially the carrying on of the business; (this clause does not refer to misconduct of one partner towards another).

- (d) that a partner, other than the partner suing, willfully or persistently commits a breach of agreement relating to the affairs of the firm such that it is not reasonably practicable for the other partners to carry on the business in partnership with him; (this clause refers to the misconduct of one partner to another).
- (e) that a partner, other than the partner suing, has in any way transferred the whole of his interest in the firm to a third party;
- (f) that the business of the firm cannot be carried on save at a loss; or
- (g) on any other ground which renders it just and equitable that the firm should be dissolved.

*Note.*—The right to get dissolved through the Court is not subject to any contract between the partners. A partner's claim to a decree for dissolution rests in its origin not on a contract but on an inherent right to invoke the court's protection on equitable grounds in spite of the forms in which the rights and obligations of the partners may have been regulated and defined by the partnership contract.

**Settlement of Accounts on Dissolution.**—In settling the accounts of a firm after dissolution, the following rules shall, subject to agreement by the partners, be observed<sup>11</sup> :—

Losses are to be paid first out of profits, next out of capital and finally by the partners individually in the proportions in which they were entitled to share profits. The

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<sup>11</sup> Section 48. Indian Partnership Act, 1932.

partners cannot by any agreement among themselves escape their liability to third parties. They may change each other's rights *inter se* but they cannot affect the rights of third persons.

The assets of the firm shall be applied in the following manner and order:—

- (i) in paying the debts of the firm to third parties;
- (ii) in paying to each partner ratably what is due to him from the firm for advances as distinguished from capital;
- (iii) in paying to each partner ratably what is due to him on account of capital; and
- (iv) the residue, if any, shall be divided among the partners in the proportion in which they were entitled to share profits.

*Note:*—A partner in the absence of special circumstances has no right to get the property divided in specie. He has a right to have the assets sold in order to provide a fund whereby the liabilities of the firm may be discharged or the rights of partners adjusted.

**Law relating to Payment of Firm Debts and of Separate Debts.**—The joint estate is to be applied in payment of the joint debts, and the separate estate in payment of the separate debts, any surplus that may be left over from either estate being carried over to the other. According to this rule joint creditors, that is, creditors of a partnership firm, cannot touch the separate estate, that is, the private property of individual partners, until after payment in full of the separate debts. They take the surplus only after the

payment of those debts. Similarly, it is only a creditor of the firm who has a right to have his debt first satisfied out of the firm property. A creditor of a particular partner has no such rights. A creditor of the firm takes precedence over a creditor of a particular partner. (Sec. 49.)

The property belonging to the firm cannot be attached or sold in execution of a decree other than a decree passed against the firm. The Court may, however, on the application of the holder of a decree against a partner make an order charging the interest of such partner in the firm and may appoint a receiver for the share of such partner in the profits, and direct accounts to be taken and make an order for the sale of such interest. The other partners are at liberty to redeem the interest charged or in the case of sale being directed, to purchase the same. The partners may also bring a suit for dissolution and accounts.



### REGISTRATION OF FIRMS

The Indian Partnership Act, 1932, has introduced a new element, that of the registration of partnership firms. This provision came into force on the 1st October, 1933, exactly a year after the main Act came into operation. A firm can be registered by sending a statement on a prescribed form with the necessary fee to the Registrar of firms of the area concerned. The statement should be signed by all the partners and should contain the following particulars<sup>12</sup> :—

1. Name of the firm.
2. The principal place of its business.

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<sup>12</sup> Indian Partnership Act, 1932. Section 58.

3. The names of other places where the firm carries on business.
4. The date on which each partner joined the firm.
5. Names in full and the permanent addresses of all the partners.
6. The duration of the firm.

In England the registration of partnership firms is compulsory under the Registration of Business Names Act. It is true that in India the registration of firms is optional, but the disabilities, disadvantages, or drawbacks of unregistered firms and their partners are so great that it makes registration almost obligatory, particularly for all large firms. The disabilities are the following<sup>13</sup>:—

1. In the case of an unregistered firm, if any dispute arises among the partners or between a partner and the firm or between a partner and ex-partners, and the dispute is based upon the rights given by contract or agreement between the partners or upon the rights conferred by the Partnership Act, then no suit can be brought to settle such disputes and if such a suit is brought it will not be entertained but dismissed forthwith.
2. If the firm is unregistered and it becomes necessary for the firm to bring a suit against any outsider to enforce any contract or transaction which was entered into between the firm and the outsider, then such a suit cannot be brought. Such a firm, therefore, cannot sue to recover a loan given to an outsider or the

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<sup>13</sup> Indian Partnership Act, 1932. Section 60.



price of the goods supplied to him or to recover damages for losses caused by such outsider in respect of any transaction.

It should be noted that a suit by an outsider against the firm is not prohibited; it is only a suit by the firm against an outsider which is prohibited.

It should be remembered that the prohibition in this clause applies to firms which are based on contracts with outsiders. If an outsider unlawfully encroaches upon the premises of the firm or commits any other mischief or injury, the unregistered firm can bring a suit in such cases as the right is not based upon any previous contract with the outsider.

Not only can a partner not sue the firm or other partners or the firm sue an outsider on a contract, but also in a suit by an outsider against the firm on a contract the defendant cannot make an indirect claim by way of set-off.

When a plaintiff A brings a suit against a defendant B and B says that A owes him a particular amount and that this sum should be deducted from what A claims against B, such a claim by the defendant B is known as a set-off.

Exceptions to the rules mentioned above are the following:—

1. A suit by a partner to dissolve the firm or for accounts of a dissolved firm or his share of the assets of a dissolved firm.
2. Suit or application by the official assignee or receiver in order to realise the property of a partner who has been declared insolvent.

3. Suits in connection with registered firms which have no place of business in British India or whose place of business is in such a locality as is excluded by Government notification from the operation of this section.
4. Suit or claims of set-off not exceeding Rs. 100 in amount which are of a nature cognizable by small causes courts.

This last 'exception' clearly indicates that the registration of firms is aimed at large firms and not so much at small ones. There is no time limit for the registration of firms. It can be effected just before the suit is filed.

### GOODWILL

The term 'Goodwill' is a commercial rather than a legal one. This is a matter which frequently arises in connection with partnerships. Goodwill is not a tangible property, still it has a value, and like every other commodity can be sold and purchased. If people are willing to pay a price for a certain thing it naturally has a value. The question, therefore, that arises is why and how an intangible property can have value, and if it has a value, how can the same be calculated or determined? This can best be explained with the help of an illustration. Supposing A has a drug store in a certain locality doing good business and has been making good profits for several years. For some reason he wants to retire from the business and would like to sell his store. B is anxious to go in for a drug store business in the same locality and is willing to purchase it. B agrees to pay the

invoice price of all the medicines and other articles in the stock, the cost price for the fixtures, less depreciation at a certain rate per annum, and a certain sum for 'goodwill'.

Now suppose that A instead of retiring continues to remain in his business. B then will have no other option but to start his business in a new shop. The location of the new shop not being so good will not be able to attract many customers, at least in the beginning. It also takes time for a new business to get many customers. Human nature is a slave of habits and is slow in making changes. People prefer to make purchases from the same shop till they are dissatisfied with the dealer, or they find better articles or equally good articles cheaper elsewhere. For these reasons, in the beginning, the daily average sale in the new shop will be considerably less than in the old shop. The overhead expenses in the two shops will not be materially different but the average turnover of capital in A's shop being very much more than in B's shop, the cost per unit in the former will be less than in the latter, consequently the profit in A's shop will be very much more than in B's shop. If B could purchase A's shop he would get almost all the advantages of an established business because most of the customers would continue their patronage of the old shop so long as they were not dissatisfied with the new proprietor. It is clear, therefore, that the purchase of a well-established business which has a large number of customers and is earning a good profit is a distinct advantage; it brings increased business and increased profit from the very beginning. It is for this advantage that people very willingly pay a price. This advantage, and the price which the buyers are willing to pay for it, are both called 'goodwill'.

The word "goodwill" has not been defined in the Indian Partnership Act, 1932. According to some, "goodwill is the benefit accrued to a business through its reputation and connections", and according to others "it is the probability that the old customers will resort to the old place". Both these definitions fit in well with the illustration given above. Goodwill is an asset which has a monetary value and is taken into consideration at the time when a new partner is taken into the business, or an existing partner retires, or the firm is dissolved. On the dissolution of a partnership the partners have a right to get the goodwill sold. Legal representatives of the deceased partner and the retiring partner have an interest in the goodwill and are entitled to a share in it. When a new partner is taken he generally pays, in addition to the capital, a certain sum of money called premium for the goodwill of the firm. (Sec. 51.) The existing partners are entitled to this premium, and the amount is divided among them in the proportion in which they share the profits. The old partners have a right to take their respective shares of the premium money out of the business, or they may keep their respective shares in the business and get their capital holdings increased to that extent.

Sometimes the value of goodwill has to be calculated without putting it to sale. For instance, a partner retires, and according to the term of the contract he has to be paid the value of his share of the goodwill. The Act is silent about the method of calculating goodwill. The value of goodwill is generally calculated at three to five times the average annual profit of the last three years. Whether it should be three times or more, will depend first, on the nature of the business, that is, whether it is progressive or retrogressive; second, on the effectiveness of competition

that it may have to face. In England three years' profits ordinarily represent the value of goodwill, the reason being that in three to five years it is expected that a new business will be able to enlist a large number of customers which will increase the average daily turn-over. Consequently, the cost of production or business as the case may be, will decrease and profits will increase and in course of time the new business will have a goodwill of its own. The loss to a new business is for a few years only and at the beginning. It is, therefore, necessary to pay a compensation value for the loss of profit for these few years. This is the reason why three to five times the average annual profit is considered to be an adequate and reasonable value for goodwill.

#### ADVANTAGES AND DISADVANTAGES OF PARTNERSHIPS

**Advantages.**—A partnership partakes of several of the characteristics of the individual entrepreneur organisation. Like that organisation the partnership enjoys great facility of formation, is inexpensive to establish and is widely applicable to varying industries. Unlike joint-stock companies of which I shall discuss in the next chapter, it is not necessary for starting a partnership business, to draw up a number of formal documents and fulfil various conditions, or pay organisation fees and taxes and obtain the special sanction of the state. It is true that in some countries partnerships are now to be registered. In India it is optional. But even in the countries where registration is compulsory, it is just a formality and in no way interferes with the establishment of a business.

{The establishment of an individual entrepreneur business is dependent on the means, resources and convenience of one person only. In a partnership, on the other hand, two or more persons must combine together to form a business; naturally certain considerations arise in this connection which do not exist in the case of individual enterprise.) We have already noticed that the activities of each partner are binding on the firm, and that each partner has an unlimited liability. It is, therefore, essential that in choosing partners one should be careful and cautious and must have such persons in whom one has complete confidence. This then is the first limitation to the establishment of a partnership. The underlying idea of a partnership is that partners are expected to bring something to the business either by way of capital, business experience or technical knowledge. And it may be that very few of the persons on whom you have confidence possess one or the other of the requisite necessities. This is a further restriction in the choice of partners. Again, some of those in whom one has confidence and who possess capital etc., may not be willing or be in a position to go in for business, while others who are willing to go in for business may have a preference for a different business, and even if the business be the same they may differ with regard to its location. Finally, they may agree as to the nature of the business and its location and still differ in regard to the terms of the partnership agreement.

{There are several difficulties and limitations in finding partners; and consequently the field of choice for the selection of partners is very narrow. There is no such impediment in the case of an individual entrepreneur organisation. There you are your own master.) You have not to depend on the wishes of others and their conveniences. If you decide

to go in for a particular business at a particular place, and if you have the requisites for it, you can go ahead and start the business immediately. But in the case of a partnership one has not that freedom on account of the limitations stated above; but once you have selected your partners there will be no longer any such difficulty. You can then start the business with the same facility with which you can start an individual enterprise. In conclusion, we can, therefore, say that the facility of formation in the case of a partnership business is great but not quite as great as it is with the individual entrepreneur organisation.

The effect of motivation on the productivity and efficiency of the partners is also similar. It is high but not so high as in the individual enterprise. The relation between effort and reward being direct, the partners will be induced to increase their efforts because it is expected that with increased efforts profits will increase. But as is true of all joint efforts and rewards, partnerships have the effect of modifying the directness of relation between effort and reward. Cases of manipulation and fraud by partners are not altogether unknown. Apart from this it is not uncommon for a partner to feel that it is due to his special knowledge, or hard work, or efficiency, or capital that the profit of the firm is higher and that the other partners are reaping the benefit at his cost. This might damp the spirit of partners and they might not feel sufficient impetus to increase their efforts. But the fear of the loss of profits to all the partners and in addition the risk of unlimited liability involved in such business will be strong enough to induce each and every partner to be active and alert, and, therefore, there can be no material reduction in the impetus of the partners to increased efforts.

{The implication of motivation is that the more impetus the partners will feel, the more they will work and with their increased effort and efficiency the cost of production will be less and, therefore, the profit will be greater.} There are other factors also—other than motivation—which reduce the cost of producing goods. A partnership firm no doubt derives benefit from the combined ability and resources of the partners; in addition, it is also possible to introduce some degree of differentiation and specialisation, so that each partner may take the responsibility to supervise that part of the business for which he has the greatest aptitude and efficiency. If a man is given a job for which he has the greatest liking, his efficiency in that work will certainly be more than in another for which he has less. He will also take less time to learn and master the trade. } If a man has only one job to supervise he can get more time to do it. He will, therefore, be able to train his men better and will be able to guide them more efficiently and effectively, with the result that the cost of production will go down and the profit will increase. }

{Thus, there are two factors which reduce the cost of production. One is psychological, *viz.*, impetus, and the other, efficient organisation. In partnerships the effect of impetus is less and that of superior organisation more to bring about a reduction in the cost of producing goods; while in individual enterprise it is the other way. }

{A partnership firm no doubt derives a benefit from the combined ability and resources of the partners as it is often found that the combined judgment of several heads is an advantage. } For instance, one partner may look at a problem from one point of view, while another from another point. If the two join together to thrash out the problem, each will



get the opportunity to know the other side of the question as well. After the problem has been analysed and discussed thoroughly by the partners, the final decision may be very much better and more useful.

With the increase in commerce and industry the need of larger capital becomes apparent and necessary. The resources of a single individual are not enough to cope with the demand for increased capital, hence the necessity of collecting it from several persons. In a country there are very few persons who have plenty of money. Even of the few who have most are either not inclined for business or are not prepared to risk all their resources in a single enterprise, and it is more so on account of unlimited liability. If a large amount of capital is necessary for a business undertaking it becomes necessary for several persons to combine together and pool their resources. Hence the importance of partnership and the facility with which it can collect large capital. Historically also, the most important advantage of a partnership lies in the possibility of collecting greater capital than is possible under a single individual. The business can also be on a large scale and can derive all the advantages and facilities of a large scale business.

(The flexibility of the firm organisation is another advantage.) The partnership is a contractual relation. If in course of time the business conditions change and thereby it becomes necessary to change the objects of the firm and to adjust its membership and capital, these can be effected easily if all the partners agree.

(It has already been stated that the liability of each partner is unlimited. This fact gives the partnership excellent credit.) So long as the partners have sufficient private property the sellers of goods and lenders of money will easily

give the necessary accommodation to a partnership firm because they will be sure of realising their dues from the private property of the partners in case the assets of the firm are not sufficient to pay their dues. The borrowing capacity of a firm is, therefore, much greater than that of a single individual. It is also greater in proportion to capital than that of joint-stock companies and other limited liability organisations.

Finally (in partnerships the minorities may often secure adequate representation and their interests may be sufficiently safeguarded. The usual business affairs are ordinarily conducted by majority votes but in vital matters, such as, the taking of a new partner, the consent of every partner is necessary.) Apart from this, the fear that a dissatisfied partner may withdraw and dissolve the firm or may so hamper its affairs as to make it necessary to buy him out make the majority partners more considerate of the minority partners and their interests. It is no wonder, therefore, that the minority partners do not like to incorporate their firms.

**Disadvantages.**—Partners are often found to disagree, they sometimes hold conflicting opinions concerning their business, and these may lead to friction within the firm. The larger the number of the partners, the greater is the difficulty in securing harmony of interests in management. Too many cooks may spoil the business broth, and a divided council may act with indecision, though ordinarily in most questions of management a majority decides. Therefore (the chief disadvantage of the partnership, as compared with the individual entrepreneur, lies in a frequent lack of prompt and united management.)

There are two reasons why the number of partners in a partnership should be limited. The larger the number of

partners the greater is the chance of friction, leading to unfortunate complications. In the interest of harmony, it is desirable to have a limited number of partners; it calls for a degree of common interest which can find expression in concurrent action. Again, the law in India restricts the number of partners in a firm to 10 in banking and 20 in other than banking business. Thus, the number of partners being limited, the amount of capital which can be raised by a firm is also limited. A few firms, such as J. P. Morgan & Co. may be formed in America and other countries in which a group of very wealthy men contribute large sums to organise a partnership business. But they are the exceptions and they only illustrate the rule. (Ordinarily, a partnership can collect more capital than an individual enterprise, but it is much less than the more highly developed forms, viz., the joint-stock companies to be discussed later on.)

(The unlimited liability of individual members may be regarded as excessive for most purposes. It, therefore, prevents many people with capital to invest it in a partnership business.) When the business is on a small scale and the business relations among the partners are very personal, the latter would not feel the personal liability for firm obligations so burdensome. The modern tendency is for large scale business requiring large amounts of capital and extensive credit operations. The personal liability of the partners has, therefore, increased beyond all reason. The larger the number of partners and the scale of the partnership business, the greater is the individual liability. This means a cumulatively concentrated risk.

Under common law (each partner has an unlimited liability. For this reason, it is not possible for investors who

have not the capacity or the desire to take part in the management to join a partnership.)

Not only this, but when a partner desires to leave a firm and to transfer his share in a partnership business, he can do this only with such difficulty that presents disadvantages to many investors. (The only person to whom he can sell his share is a co-partner.) To a stranger, it is possible to sell the share with the consent of all the partners. (Such a condition so limits the market that it can only be sold at a sacrifice.)

Further, the responsibility of the withdrawing partner does not cease with the sale of his share. He remains responsible even after the sale of his share to the creditors for debts incurred before the withdrawal if those creditors are not actually informed of his withdrawal. He is also liable to other creditors unless a constructive notice has been given to them.

The possibility of the dissolution of a partnership at the death, lunacy or insolvency of any partner is a disadvantage.

**Social and Economic Points of View.**—It will be better if the discussion is on the same line as it was in the case of individual entrepreneur organisation. Partnership follows the principle of adoption in order to perpetuate itself. Often one goes out of the family fold to choose partners. Suppose that A, B, C and D are the four partners in a business. They need not be of the same age, and even if they are, it is not necessary that all of them should retire or die at the same time. It can easily be expected that they will leave the firm at different periods. After working successfully for say, ten years, A retires, and according to their agreement his son  $A_1$  is taken as a partner.

It has often been found that experience and old age tone down the early vigour in men. They lose much of their

dash and go of youth.  $A_1$ , the new partner, who is a young man, gets the best opportunity of learning the intricacies of the trade, and also receives proper guidance from B, C and D, the senior partners. They prevent deterioration from setting in in the partnership business as is often the case with the heirs of individual enterprises. At the same time  $A_1$  who has all the vigour of youth infuses enthusiasm and new life into the dormant spirit of the senior partners. Thus there is a healthy blending of the young and the old, and the business continues with a fresh lease of life. The same process is repeated from time to time when B, C and D retire from the business giving place to  $B_1$ ,  $C_1$  and  $D_1$  respectively. In this way new blood is injected into the partnership from time to time and thereby the firm continues its existence and in an efficient and healthy condition. There is also another side of the picture, *viz.*, the danger of dissolution either on account of the incapacity of the partners or due to misunderstanding among them. In conclusion, we can then say that while partnership provides a somewhat better means of perpetuating itself, the existence of that partnership itself at any given time is more precarious.

It has already been discussed under 'advantages' that motivation in partnership works under the friction of excessive caution and divided counsels. But the fear of unlimited liability keeps the partners active and alert and spurs them to work with zeal. Besides the superior organisation of partnership increases its productivity and society is benefited thereby. On the whole partnerships bring a greater number of economic advantages to society than individual entrepreneur organisations. Further, the unlimited liability of all the partners gives a still greater protection to the creditors. On the other hand, the larger the business, the greater the

need of a centralised management which is not easily possible in a partnership, and the difficulty of raising a large capital due to unlimited liability restricts the scale of business. For these reasons the field for the common-law partnership has steadily decreased relatively to that for other forms of business organisation.

### ✓ LIMITED PARTNERSHIP

Partnerships are based either on the principle of Common Law or Civil Law. The former prevails in the Anglo-Saxon countries and the latter in the Latin European countries. Under Common Law all the partners have unlimited liability, while under Civil Law it is possible for a partner to have limited liability.

Unlimited liability and other obligations of partners under ordinary common-law partnership make it necessary that partners should know one another well and have absolute confidence mutually. Strangers, therefore, would not invest money in a partnership firm because they could not be sure of the amount of liability they might incur as partners. Accordingly, limited partnership has been devised, under which special partners may be admitted to the partnership whose liability for the debts of the firm should not exceed the amount they have invested. Such a form of business organisation is virtually identical with the continental *Societe en Commandite*. ...

The *Societe en Commandite* is found in those parts of Europe where Civil Law prevails and is the origin of limited partnership. According to Roman Law one or more persons could entrust their property into the hands of a slave and

trade through him with limited liability. As the business expanded this practice was gradually extended to include trading through the agency of others than slaves. Later on, when the Italian cities developed into commercial centres, the *Commenda* (derived from Latin *Commendare*, meaning to give something into the hands of another) became a commonplace form of business organisation. The *Commendator* or capitalist partner supplied the funds or goods while the *commendatarius* or active partner managed the venture. In the beginning the relationship was for a temporary period, say, a single voyage, or similar enterprise, and the active partner invested no capital. With the further expansion of the business it became more permanent and more highly organised, and the active partner not only directed the business with unlimited liability, but also invested capital himself.

Thus, there were three distinct stages in its development. In the beginning, the capitalist alone invested funds and the property or the business was managed by a slave. In the second stage the management was transferred into the hands of a third party other than a slave. This third party only managed the business and contributed no capital but his liability was unlimited; while in the third stage the third party or the active partner not only managed the business but also contributed capital in addition to the fund invested by the capitalist. In all the three stages the original capitalist or the sleeping partner had limited liability, while the active partner had unlimited liability.

Professor Haney is of opinion that probably no historical connection exists between limited or commandite partnership and the common-law form. According to him the basic principles of the two forms are different. Limited partner-

ship is based upon the association idea, and the other upon the idea of the individual personality; for, as we shall see, in the one the members may merely participate in profits and losses, whereas in the other they are personally liable for the debts of the firm.

It is not possible to organise a limited partnership business in India because no such law has ever been passed in this country. In the United States limited partnership was introduced from the French law early in the nineteenth century and in England almost a century later in 1907. In both the countries it has been created by statute.

#### **Characteristics of Limited Partnerships.—**

1. In a limited partnership there are always two classes of partners: 'general or active partners' and 'special or sleeping partners'.
2. There is at least one general partner, there may be more, and the management of the firm's business is in his or their hands.
3. The general partners have unlimited liability, that is, they are responsible for all the debts of the firm, while the liability of the special partners is limited to the amount of their investments.
4. The special partners merely contribute capital and share in the profits, but they cannot take part in the management, nor are they allowed to act as agents of the firm.
5. Limited partnerships must be registered.
6. The contribution of the special partner must be fully paid up and in cash.
7. Such a partnership is not dissolved by the death, lunacy or bankruptcy of a limited partner.



**The Advantages of Limited or Commandite Form Over Ordinary Partnership.**

In this type of partnership organisation the motivation or the impetus of the partners for efficient management is as strong as in the ordinary partnership under common-law. In addition, it furnishes a single direction of management which may act with greater unity and promptness. Moreover, it would suit many investors who either have no time, or inclination to take part in the management of the business, and are also not prepared to undertake unlimited liability. Such capitalists by becoming special partners can not only keep their liability within a reasonable limit but also earn a profit for themselves, at the same time enable an industrial leader who may not have sufficient capital to secure the necessary funds to put his genius and energy at the service of society. This additional capital the general partner can secure without losing his control over the management of the business. Besides, a sleeping partner, or one desiring to retire, can leave his property in limited partnership without undue liability.

**Disadvantages.**—There are two distinct disadvantages of this form of business organisation. One for the capitalist—the special partner, and the other for the creditors. It confers a very great power to the general partners. Unless fraud can be proved special partners have no right to interfere in the management, with the result that the investors' interest may be abused. At the same time, it is not very easy for a special partner to withdraw from the business because a forced sale of his share might put him to a heavy loss. Further, the usual experience is that the capitalist exerts an influence over the non-capitalist. Though the special partners cannot take part in the management yet they have been found to pull the wires and in practice they

exert a considerable influence over the general partners. If the two classes of partners choose, they can combine to defraud the creditors. The two together can manipulate to put a sufficiently large amount of money in the possession of the special partners fraudulently, which would more than offset the property liability of the general partners who have an unlimited liability and thereby they can make failure profitable.

It may be asked why it is that such a partnership is called limited partnership and not limited liability partnership. We all agree that whatever the name or the title be it should clearly indicate what it is. It is still more important to bear in mind that the name in no case should indicate what it is not, that is, it should not give a wrong idea of the thing. It is true that the term "limited partnership" does not give a precise idea of the nature of the organisation, it simply means that there is some form of limitation, but it is not clear what that limitation is. The word 'limited' by itself does not show that the limitation is of the liability of the partners though that is the underlying idea. To obviate this difficulty one may think that it would be better and more appropriate to call it limited liability partnership because this name clearly gives the idea that the limitation is about the liability of the partners. But there is a serious objection to it and a little reflection will show that however correct and appropriate it might appear to be still it would be wrong and incorrect to call such a partnership limited liability partnership. If it is called limited liability partnership it will naturally mean that all the partners have a "limited liability". But this is not true. All the partners do not have a "limited liability". There must always be one partner (there may be more), who will have unlimited

liability, while others can have limited liability. For this reason it would be wrong to call it limited liability partnership. It is true that the term "limited partnership" does not give a clear and precise idea of the nature of the organisation for the reasons already given, but, at any rate, it does not convey wrong or incorrect information. In the absence of any better term 'limited partnership' is more suitable and may be regarded as the next best.

## CHAPTER III

### JOINT-STOCK COMPANY ORGANISATION

There are three shortcomings of the partnership as a form of business organisation, *viz.*, its limitations for amassing capital, its easy disruption, and its lack of facility for centralised management. For the modern industries requiring large capital and full of risks there was an urgent need for a new form of business, and this was found in the joint-stock idea.

The earliest kind of joint-stock company is the chartered. The grant of a charter is one of the exclusive privileges of the Crown, and the Crown has from time to time exercised it in furtherance of trading enterprise. Examples of such grants are the Merchant Adventurers of England, chartered by Richard II (1390); the East India Company, chartered by Queen Elizabeth (1600); the Bank of England by William and Mary (1694); the Hudson's Bay Company; the Royal African Company; the notorious South Sea Company; and in later times the New Zealand Company, the North Borneo Company, and the Royal Niger Company. Chartered companies had, however, several disadvantages. (i) A charter was not easily obtainable and was costly. (ii) The member could not be made personally liable for the debts of the company, and once granted—though only for defined objects (iii)—such a company was invested with entire independence and could not be kept to the conditions imposed by the grant,

which was against public policy. A new form of commercial association was wanted, free from these defects, and it was found in the common-law company—the lineal ancestor of the modern trading company. The common-law company was not an incorporated association, but a great partnership with transferable shares. Companies of this kind multiplied rapidly towards the close of the 17th and beginning of 18th countries, but they were regarded with strong disfavour by the law because they were utilized by unscrupulous persons to promote fantastic and often fraudulent schemes. The Bubble Act of 1719 declared such companies to be common nuisance and regulations were introduced in 1825. It was in 1844 that the first Companies Act was passed in England introducing incorporation of companies without the necessity of applying for a charter or special Act.<sup>1</sup>

**Definition.**—(A joint-stock company is formed when a number of individuals associate for profit and put their capital together, divided into shares that are transferable.) To be a member, one must own shares in the company. Its characteristics are, therefore, that it is formed as a result of contract among the members, that it does not require either a charter or a certificate or a grant from the Government and that the liability of the members is personal.

(The joint-stock company is a transitional form of business organisation and is intermediary between a partnership and the business corporation of today.) In the history of company organisation, the joint-stock company marks only a process of development and helped the business corporation of the present day to be evolved out of the original partnership stage.) There are mainly two classes of joint-stock

<sup>1</sup> *Encyclopædia Britannica*, Vol. 6, p. 141.

companies, *viz.*, common-law and statutory. The common-law form is almost a partnership; the statute-law form is almost a corporation.

**The Difference Between the Ordinary Common-Law Joint-Stock Company and the Partnership is as follows:—**

1. The capital of a joint-stock company is divided into shares and the owner of these shares does not need the consent of the other members in order to transfer his shares whenever he so desires.

2. The management of a joint-stock company may be entrusted to a board of directors whose actions, so long as of course the directors are within their limits, are binding on the company.

3. The death or disability of any member does not dissolve a joint-stock company.

In these differences, the point to be noted is that the members of a joint-stock company need have no close personal relations with one another. It may often be that they are entire strangers and as any change in membership does not need their consent, the nature of the business does not warrant any personal relations. Then again, they have unlimited liability, *i.e.*, they are responsible for the company's liabilities in the same degree as are partners. As against this, it can be pointed out that a statutory joint-stock company is similar in organisation to a corporation but for the fact that in the former, the liability is generally unlimited, though it may be limited by statutes.

**Difference Between Joint-Stock Companies and Business Corporations.**

1. Joint-stock companies are not legal entities as a corporation is; in other words, they have no legal personality

distinct from the members. This difference is the most important.

2. Joint-stock companies are formed as a result of a contract among the members to which they all agree, and are not dependent upon a charter or a certificate or a grant from the Government.

3. If statutes do not intervene, members have unlimited liability.

**Articles of Association.**—At the time when a joint-stock company is formed, the members have to execute ‘articles of associations’, or ‘deeds of settlement’. The articles must clearly give the following points: (1) the aims and objects of the company; (2) the amount of stock; (3) the number of shares into which the whole capital would be divided; (4) the way in which these shares are to be sold or distributed or assigned; (5) the rights that the members would enjoy and the obligations that they would have to discharge; (6) and also, the number of directors, their duties, privileges and jurisdiction. A great advantage that is enjoyed by the members of a joint-stock company, in common with those of a modern business corporation, is that the death or incapacity of a member does not dissolve the association. This advantage is secured by means of an agreement, the other terms of which are that the shares of the company should without difficulty admit of changing hands, that a board of trustees should be responsible for the property of the company and that no member should be allowed to act as an agent. (7)

### **The Advantages of the Joint-Stock Principle over the Ordinary Partnership.**

1. The one most important limitation of partnership was that it could not raise a large capital. But a joint-stock business by selling a large number of transferable

shares can collect together a much greater aggregate fund.

2. The fact that only the authorised agents of the company can bind it and the members reduces the risk as compared with partnerships.

3. The joint-stock organisation furnishes a more efficient machinery for management because it is under the direction of an expert board of directors.

4. The joint-stock principle results in a greater stability of organisation, because the shares are transferable and the liability to disruption at any given time is very much reduced.

### **Advantages of Joint-Stock Companies over Corporations.**

1. A joint-stock company does not have to pay franchise and other taxes which corporations have to. If it is to be made subject to these taxes, the statute must expressly provide for it, while its members are taxable as partners rather than as stock-holders in a corporation.<sup>2</sup>

2. A joint-stock company can easily be dissolved, for it is formed as a result of a contract. So members can by common consent declare the company insolvent and wind it up. A corporation cannot be as easily dissolved.

### **Disadvantages as compared with partnership.**

1. In a partnership the partners are active managers and act so as to improve their own affairs for their common benefit. In a joint-stock company the management is indirect and delegated.) So there is not only a greater likelihood of waste and inefficiency but also a lack of direct enthusiasm and an absence of incentive. There may, again, be a conflict of interests between the company and the management and

<sup>2</sup> *Cyclopedia of Law and Procedure*, Vol. XXIII, p. 46.



then the want of fidelity may result in manipulation, speculation and ultimate ruin.

2. A joint-stock company cannot keep its plans and financial position a closely-guarded secret and this is a positive disadvantage. The affairs of a partnership, on the other hand, cannot be so open to the public and can be easily prevented from leaking out.

Another disadvantage, not against partnership but in comparison with corporations, is that the joint-stock company lacks a distinct legal personality. This lack tells upon its permanence and makes it more easily subject to dissolution. Again, law holds that the company and its members are one; therefore, a member cannot sue, or be sued by, the company. As the company has no legal existence separate from the members, a suit between the company and its members is not only anomalous but also illogical. Finally, the members of a joint-stock company generally have unlimited liability at common-law, this is always the case, though in certain States in America, they have their liability limited by statutes.<sup>3</sup>

**Social and Economic Points of View.**—The joint-stock principle puts business organisations on a more permanent basis than partnerships and this is necessary in the interest of industrial development. The individual entrepreneur organisation can be continued efficiently when an able son succeeds his father. This principle of heredity may help the inheritor to carry on his predecessor's business as successfully or even more so. The partnership can be continued only when, on the death of any one partner, another can be adopted in his place. The joint-stock company

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<sup>3</sup> *Business Organisation and Combination* by L. H. Haney, p. 87.

thrives, however, upon an unlimited choice of members and an unfettered freedom to develop as it chooses.

From the economic standpoint also, the joint-stock company has brought about great changes. The three functions of a company—entrepreneurial, managerial, and capitalistic, as a writer calls them—are now clearly distinguished and to a large extent, separated from one another. The consequences of this may be twofold. On the one hand it can be urged that the shareholders suffer, for they have no control over the company's management and often, no knowledge even of how things are going on. On the other hand, it can be pointed out that such a differentiation of functions is but essential in modern large-scale business, for it is well-nigh impossible for one man or a group of similar men to have expert knowledge of the highly specialized branches of an industry. Moreover, this necessitates the employment of experts whose job it naturally is to go into the minute details of the business and to devise ways and means to develop it. (This again keeps the industry more or less elastic in the sense that it continues to be amenable to quick adoption of new methods and improvements.)

Considered from the point of view of society, the joint-stock organisation has showed very great possibilities. It can affect the distribution of wealth either one way or the other. It can provide greater opportunities to a large number of small investors who may purchase shares in such a company and profit from the dividends. Thus, there may be a more equitable distribution of wealth even among the less wealthy. At the same time it must be remembered that it can also accumulate capital in the hands of a few and prevent wealth from spreading over a wider population. It is unfortunate that on the whole the joint-stock organisation

has tended to over-emphasize the evil possibility and wealth has, as its result, accumulated in the hands of a few. The practical working has, therefore, been unsatisfactory from the social standpoint and many business scandals in the shape of 'promotion-frauds', over-speculation and the like have sprung out of the joint-stock organisation. But that should not blind us to the fact that it can be put on a more democratic basis and that the unsuccessful working in practice does not mean that there is something inherently wrong in the organisation itself.

If we remember this, we can easily realize what should be the attitude of society to this organisation. The joint-stock principle has to be applied more widely and attempts should be made to eradicate the evils that have crept in. A cleaner business deal and the elevation of the level of commercial morality can easily do away with these evils and would surely ensure financial stability and a better distribution of wealth. But at the same time, society should take lesson from the defects attendant upon this organisation and should sparingly allow it to replace the individual entrepreneur organisation wherever the latter has worked successfully.

### CORPORATION ORGANISATION

**Definition and General Nature.**—I shall begin this section with two definitions on Corporation—one by Sullivan and the other by Haney.<sup>4</sup> "A Corporation is a body consisting of one or more natural or artificial persons established by law, usually for some specific purpose or purposes, and continued by a succession of members."<sup>4</sup> "A Corporation is

<sup>4</sup> Sullivan, *American Corporations*, p. 1.

a voluntary autonomous association formed for the private advantage of its members, which acts with compulsory unity, and is authorised by the State for the accomplishment of some public good.<sup>5</sup>

The essential characteristics of a corporation are:—

- ✓1. It is an association and stands for group activity.
- ✓2. It is a creation of the State and derives all its authority from there.

A corporation may be established either by special laws authorising a particular company to function or by general laws. (In the former case, an act of the legislature has to be passed every time a company is to be established. The Imperial Bank of India and the Reserve Bank of India were established by the passing of special Acts to that effect in the Indian Legislative Assembly in 1920 and 1934 respectively. All corporations in a country are established under general laws except those by special laws.)

- ✓3. The corporation is of voluntary formation, but of compulsory continuance. People have the freedom to organise or not to organise a company, but once a company is formed it cannot be dissolved till the expiry of the period for which it is formed or till it is wound up with the permission or by the order of the court. (Even if a corporation ceases to do business it still exists in the eyes of the law and may sue or be sued in the courts till it has been formally wound up.)

- ✓4. The corporation is a self-governing organisation.

- ✓5. The corporation has an existence of its own separate from its members. It has an artificial legal personality.

<sup>5</sup> Haney, *Business Organisation and Combination*, p. 93.

This is its chief distinguishing feature as against joint-stock companies.

6. Usually corporations now have limited liability but this is not an essential character, because corporations have existed with various degrees of liability for its members running from the amount invested upto complete personal liability. Limited liability was not a feature of early English corporations; it came after the corporation.

7. Finally (the function of the corporation is public because the government gives it the necessary permission on the assumption that the public will be benefited by its existence. ) Though it is a voluntary association of individual persons, and the motive is private gain, yet it is true that in giving permission for such an association activity the government has in mind the utilization of private interest for public weal. )

**Advantages.**—The incorporation makes association stable. The second advantage is its limited liability. This feature is not essential, it is not necessarily associated with the corporation, but in actual practice only limited liability companies are formed. A third advantage lies in the increased efficiency of direction. The skill and flexibility of administration may also be increased as a result of limited liability and the entity idea. A company may secure the services of the best and the most efficient directors irrespective of their other interests, and the liability of the shareholders being limited, these directors may not mind taking the risk and purchase the requisite number of shares of the company. In the fourth place the joint-stock corporation is the best form of business organisation to raise a large capital. The United States Steel Corporation has a capital of \$1,330,845,000. The Tata Steel and Iron Company has a capital of

Rs. 12,45,94,400.<sup>6</sup> There is no doubt that such a large unit could not be built up under any form other than corporation.

**Disadvantages.**—Limited liability is one of the causes of the many evils of the corporate form. The managers and directors lack personal interest. This leads to inefficiency and waste; and often there is a clash of interest among the directors, officers and shareholders leading to manipulation, fraud and losses. The legal entity privilege conferred on the corporation is another cause of the evil. It is true that directors and other officers are required to be scrupulously honest and they are liable to be punished for fraud etc., but fraudulent measures are always difficult to prove. Further, an individual or a minority cannot maintain an action at law against the directors on the ground that the corporation is a separate legal person, that the directors are the agents of the corporations and not of the stockholders, and that the corporation has suffered the injury, not the stockholders. This increases the risk of investment and in spite of the advantages of limited liability it restricts the number of persons who would like to invest in the securities of a joint-stock company. The other disadvantages are as follows:—  
 (1) the credit is restricted and the company can, therefore, borrow a limited amount only in proportion to its financial responsibility, (2) the expense of forming a corporation is considerable, (3) prompt action may be hampered because of the time intervening between its meetings, and finally, (4) the Companies Act makes it imperative for persons dealing with a company to be sure of the power and authority of its officers to act, because in some cases their acts may be

<sup>6</sup> Paid-up Capital Rs. 10,45,94,400 and Debenture Rs. 2,00,00,000.

binding on the company only when approved by a particular body or sanctioned by specified majorities.

**Social.**—The corporation has benefited society because it encourages investment, affords efficient direction of large-scale industry and has made the business unit more stable. At the same time, society loses because the motivation behind the thing is not direct. Again, the corporation brings with it limited liability which stands in the way of a full development of a sense of responsibility. This imperfect responsibility causes a material decrease in the intensity of industrial motivation. It has other consequences, too, for it goes against the social principle that power should be accompanied by responsibility. The members never feel themselves fully responsible for anything that they do, with the result that financially very often the public and the shareholders suffer, while they escape the clutches of law for any acts that violate criminal law. Practical experience has shown that it is very easy for the officers of a corporation to take shelter behind the entity which has 'no soul to be damned'. Further, the corporation has made monopoly easier. Though, of course, it may be unjustified to attack it for this, for even a desirable institution may have abuses, it should not be forgotten that there is such a possibility which needs remedying. Finally, corporations are regulated by legislation, consequently, powerful business men and industrialists may try to influence the legislature, which very often ends in a wide-spread political corruption. This is particularly true of public-service companies and in those cases where protection is sought.)

## JOINT-STOCK COMPANIES ACTS IN ENGLAND AND IN INDIA

All our company laws are based on the company law of England. In the United Kingdom the first company Act was passed in 1844, and in India in 1850. Subsequent enactments in India have closely followed those in the United Kingdom. The important ones are given below:—

United Kingdom	India
1855. The first Limited Liability Act.	1857. The first Limited Liability Act.
1857. The Joint-Stock Banking Companies Act.	
1858. Joint-Stock Limited Liability Banking Companies Act.	1860. The Joint-Stock Limited Liability Banking Companies Act.
1862. The Companies Act.	1866. The Indian Companies Act.
1867. The Companies Act.	
1877. The Companies Act.	
1880. The Companies Act.	1882. The Indian Companies Act.
1908. The Companies (Consolidation) Act.	1913. The Indian Companies Act.
1929. The Companies Act.	1936. The Indian Companies (Amendment) Act.

(The Joint-Stock Companies Act was passed in India in 1850 and it substantially followed the English Act of 1844. It was the first of its kind and naturally brought about a great change in the situation. The Supreme Courts of Calcutta, Madras and Bombay were empowered to register unincorporated companies with shares or stocks, transferable without the consent of all the partners, and companies with literary, scientific or charitable objects. The procedure was



this: At the time of submission, every petition for registration had to be accompanied with a 'Deed of Partnership' and a list of Directors and Shareholders intended to be Registered Officers of the Company, and also had to contain particulars about (i) the names of partners, (ii) the name and style of the company, (iii) the names of the principal places of business, (iv) the amount of capital, and (v) the number of shares into which it was divided. Between 1850 and 1857, fourteen companies were registered in Bengal alone, the first among them being the New Oriental Life Assurance Company.)

(The first Limited Liability Act in India was that of 1857, under which the first company to be incorporated in Bengal was the Calcutta Auction Company, Limited.) Under this Act again, were registered anew and with limited liability many companies which had been registered under the earlier act. (The first Joint-Stock Banking Companies Act was passed in India in 1860, and the first to be incorporated in Bengal under it was the People's Bank of India, Limited.) (The Consolidating Companies Acts were those passed in 1866, 1880 and 1913, modelled upon similar acts of 1862, 1867 and 1908 of the United Kingdom.) An Act was again passed in England in 1929, based upon the accumulated experience of the working of the 1908 Act. (Its provisions have been liberally borrowed in the Indian Companies (Amendment) Act of 1936, which is intended to remedy the weaknesses and defects that were manifest in the working of Act VII of 1913 for about a quarter of a century. This Act has introduced very great changes and has affected all companies in general and public companies in particular.)

<sup>1</sup> *Indian Companies Act, 1913—36* by Mozumdar and Mozumdar, p. lxxxiii.

## CHAPTER IV

### JOINT-STOCK COMPANIES

#### Section 1.—Registration and Incorporation

According to Section 4 of the Indian Companies Act, 1913, incorporation is compulsory for certain types of associations, while it is optional for others. Any association or partnership consisting of more than ten persons in a banking business, or twenty in any other, must be registered under the Companies Acts, unless it is formed under some other act of the Indian Legislative Assembly. But if the number is less than ten or twenty as the case may be, it is at the option of the promoter or organiser to get it incorporated or not. From the above it is clear that all joint-stock companies are associations but all associations need not be joint-stock companies.)

[But a Hindu joint family carrying on joint family trade or business is excluded from the operation of this section. But, if two or more joint families form a partnership, the restriction as to the maximum number (10 or 20) shall apply, but in computing the total number of partners, minor members of such families shall be excluded.]

**Classification.**—(There are two types of joint-stock companies—private and public. If the incorporation of an association is decided upon there must be at least two persons to form a private joint-stock company and not more than fifty (excluding the employee and the ex-employee

shareholders of the company), while the minimum number of persons who can form a public joint-stock company is seven, but there is no maximum limit except that the number of shareholders cannot be more than the number of shares subscribed. (Section 5.)

Joint-Stock Companies can again be divided on the basis of the liability of its members which may be one of the following:—

- ✓1. A company limited by shares.
- ✓2. A company limited by guarantee.
- ✓3. A company with unlimited liability.

**Limited by Shares.**—In the case of a company limited by shares the liability of its members is limited to the amount unpaid on their shares. ✓ It means that the members can never be required to pay more than the face value of the shares taken by them irrespective of the amount of loss to the company. It is important for readers to know that in some countries and in certain types of business the liability of the members of a joint-stock company is a multiple of the number of shares held by them. For example, in the United States of America the shareholders of banking companies have a 'double liability', that is, twice the nominal or face value of the shares held by them; though in other businesses or industries the liability of the shareholders is equal to the face value of the shares held by them. ✓ In India the liability of the shareholders is equal to the nominal or face value of the shares held by them irrespective of the nature of the business.

**Limited by Guarantee.**—In the case of companies limited by guarantee each member undertakes to pay up to a certain maximum amount to the assets of the company if

it is wound up during his membership or within a year afterwards provided its assets are not sufficient to pay its debts. ✓ A company limited by guarantee may, or may not, also have a capital divided into shares. ✓ Companies limited by guarantee are generally not trading concerns and are not formed to earn profits for their members. ✓ They are organised for charitable purposes, or for purposes of advancing knowledge in arts, science, education, or for social utilities, such as, hospitals, clubs; and the income derived from these institutions is utilised for the furtherance of that cause only. ✓ The members of these institutions usually pay a certain subscription, monthly or yearly, in addition to their undertaking to pay up to a certain amount as stated above, if the company goes into liquidation.

**Unlimited Liability.**—In the case of companies with unlimited liability there is no limit on the liability of its members, that is, each member is liable for the entire debts of the company like partners in partnerships. These are called unlimited companies according to the Indian Companies Act, 1913. ✓ This is a legacy of the past and in practice this type of company is not formed now, nor will it be possible to sell the shares of such a company if ever organised.

**Registration and Incorporation.**—If a company for any lawful purpose is to be organised, it must be registered with the Registrar of Joint-Stock Companies for its incorporation. In India there is a Registrar in every province. In case of a public company seven or more persons (two or more persons in the case of a private company) are to subscribe their names to a memorandum of association and the articles of association (if any) and file them along with several other documents required by law with the Registrar of Joint-Stock Companies of the province in which the head

office of the proposed company is to be situated for the registration of the memorandum and articles of the company and for the incorporation of the company. (Sec. 22.) The documents are:—

- ✓1. Memorandum of Association.
- ✓2. Articles of Association.
- ✓3. Consent of directors.
- ✓4. List of directors.
- ✓5. Contract of directors.
- ✓6. Declaration by an advocate.

When the Registrar receives a signed memorandum of association and the articles and all other documents, and finds that the formalities required by law have been fulfilled, he registers them and the name of the company and issues a certificate of incorporation. (Sec. 23.)

Private companies suffer from certain restrictions and also enjoy many privileges as against public companies. We shall not discuss the restrictions and the privileges here as they are given later on under the heading of 'Characteristics of Private Companies.'

In the registration and incorporation of joint-stock companies there is a difference in the procedure between a private and a public company. / A private company has to file with the Registrar of Joint-Stock Companies only three documents, *viz.*, a memorandum of association, articles of association (if any), and the statutory declaration by an advocate, and it can commence its business after obtaining the certificate of incorporation. / But, it is not so with a public company. (It has to file all the six documents mentioned above.) Moreover, a public company has still to fulfil a few more formalities; and when the Registrar is satisfied

that it has complied with them in accordance with the law, he then issues to the company a certificate to commence business. It is only then that the new company is entitled to commence business, and not before.

### ✓ MEMORANDUM OF ASSOCIATION

We shall now discuss all the documents which a company has to file with the Registrar. Two of these documents, the memorandum of association and the articles of association, are the most important. The memorandum of association is the charter of the company defining and limiting its field of operations. It contains the conditions on which alone the company is allowed incorporation, and defines the object of the company. It is the most important document with regard to its constitution and is the foundation on which the whole structure of the company is built. There is a slight variation in the contents of the memorandum of association of a company depending upon the nature of its liability. In the case of a company limited by shares the memorandum shall state<sup>1</sup>:—

1. The name of the company with 'Limited' as the last word in its name.
2. The province in which the registered office of the company is to be situated.
3. The object for which the company is formed.
4. That the liability of the members is limited.
5. The amount of share capital with which the company proposes to be registered, the different

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<sup>1</sup> Indian Companies Act, 1913, Section 6.

classes of shares into which the capital of the company is divided and the value of each of these classes of shares.

It is important to note that:—

- ✓A. No subscriber to the memorandum shall take less than one share.
- ✓B. Each subscriber shall write opposite to his name the number of shares he takes.

In the case of a company limited by guarantee the first four items of the memorandum are the same as in the previous case. The fifth item is different and is as given below:—

That each member undertakes to contribute to the assets of the company in the event of its being wound up while he is a member, or within one year afterwards, for payment of the debts and liabilities of the company contracted before he ceases to be a member, and of the costs, charges and expenses of winding up, and for the adjustment of the rights of the contributories among themselves, such amount as may be required, not exceeding a specified amount.

If the company limited by guarantee has a share capital, the items number 5, A and B of a company limited by shares are also to be added.

In the case of an unlimited liability company the memorandum contains only the first three items and also items numbered A and B of the memorandum of a company limited by shares.

✓**The Objects of the Company.**—The object clause of a memorandum is the most important and requires careful drafting, because according to the Act a company is permitted to carry on only those activities which are mentioned there.

It is based on the principle that shareholders contribute their money in the faith that it is to be employed in prosecuting certain objects, and it would be a violation of good faith if the company, *i.e.*, the majority of shareholders, were to be allowed to divert it to something quite different. So strict is the rule that not even the consent of every individual shareholder can give validity to an *ultra vires* act, that is, an act in excess of the company's powers. It is, therefore, important that all possible branches of business should be stated in detail. The objects must not contain anything which is against the Act or against the general law, but subject to that, the objects may be framed as the subscribers to the memorandum choose. In addition to the express powers stated in the objects clause, the company has an implied power to act by agents, and if it is a trading company, to incur debts and mortgage or deal with its properties, but subject to that, any contract for objects and purposes foreign to or inconsistent with the memorandum are *ultra vires* of the company and void, and being void cannot be ratified by the company. At the same time, care should be taken not to include business absolutely unconnected with the original or the primary business, otherwise, it will reflect on the efficiency of the promoters, and investors may legitimately hesitate to purchase its shares. The company is not bound to engage itself in all the activities given in the object clause. It may take up only one or a few of them. But, if a particular business is not mentioned and subsequently the directors feel that in the best interest of the company it is desirable to take it up, they shall not be able to do so as it will be illegal. It can be taken up only when the memorandum of association of the company has been changed incorporating the new business in its object clause. Such an alteration requires



the sanction of certain bodies and the fulfilment of a number of formalities, and finally, the sanction of the court. It may not be always very easy to obtain such a sanction. It will, at least, take some time to make the necessary change and in the meantime the company will stand to lose.

**A Guide in the Drafting of Objects of a Company.**—Palmer in his “Company Law and Company Precedents” has given the suggestions given below as a guide in drafting the object clauses to be incorporated in the memorandum of association of a company.

1. There ought to be a clause authorising the company to carry on, besides the particular business which it proposes to do, various other business which might be necessary for the company to carry on in order to develop its business.

2. A clause authorising the acquisition of any other similar business or amalgamation with the same.

3. There should also be a clause enabling the company to enter into any agreement for sharing profits; joint venture, etc., or any other arrangement for carrying on similar business with other persons or companies.

4. A clause authorising the company to take shares of other companies which have similar objects.

5. A clause empowering the company to promote other companies for the purpose of deriving any benefit out of the same.

6. A clause enabling the company to acquire property and rights which may be necessary for the purposes of its business.

7. A clause giving power to lend money and guarantee the performance of contracts by customers.

8. A clause giving rights to borrow money by the issue of debentures, debenture stock, etc.

9. A clause giving power to draw, make, accept, endorse, discount and issue promissory notes, bills of exchange and other negotiable instruments.

10. A clause enabling the company to sell and dispose of the undertaking of the company for shares, securities, etc., of any other company having similar objects.

11. A clause enabling the company to apply for an Act of the Legislature for any necessary purpose, in order that the company may have the power to spend money in promoting a bill for modifying its constitution.

12. A clause authorising the company to sell, lease, exchange, mortgage, or in any way dispose of, or improve, any part of its property or rights.

13. A clause giving power to pledge its uncalled capital as security for a loan.

14. A clause authorising the company to appear before a court, and to appoint legal practitioners on its behalf for defending, compounding or referring any case to arbitration.

15. A clause authorising the company to do such other acts as would be deemed expedient and conducive to the attainment of its object.

**Alteration of the Objects Clause of a Company's Memorandum of Association.**—A company can alter the objects clause of its memorandum<sup>2</sup> provided that alterations will enable it—

1. To carry on its business more economically or more efficiently.

2. To attain its main purpose by new or improved means.

3. To enlarge or change the local area of its operations.
4. To carry on some business which, under existing circumstances, may conveniently or advantageously be combined with the business of the company.
5. To restrict or abandon any of the objects contained in its memorandum.
6. To dispose of the whole or any part of the undertaking of the company.
7. To amalgamate with any other company or body of persons.

To effect the alteration a special resolution has to be passed by a three-fourths majority at a duly convened Extraordinary General Meeting, which must be subsequently confirmed by the court. Before confirming the resolution the court must be satisfied that sufficient notice has been given to every debenture holder and to any person or class of persons whose interests may be affected by the alteration, and the consent obtained or the debt satisfied of every creditor who is entitled to object. After the alterations have been confirmed by the court, a certified copy of the court's order, with a printed copy of the memorandum as altered, must be delivered to the Registrar of Joint-Stock Companies within three months from the date of the order.<sup>3</sup> The Registrar issues a certificate of the registration of the altered memorandum, which then becomes the memorandum of the company.

**Alteration of Capital.**—Section 50 of the Companies Act, 1913, provides that any alterations of capital, whether by increase, consolidation, conversion of all or any of its paid-up shares into stock and reconvert that stock into paid-

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<sup>3</sup> Indian Companies (Amendment) Act, 1936, Section 15.

up shares of any denomination, subdivisions of shares or otherwise, must be authorised by a company's articles of association, and if the articles do not sanction any such alteration, the articles must be altered by special resolution before any alteration of capital can be effected.

The procedure for an increase of capital is governed by the articles, and the increase must be effected by the company in a general meeting, and the resolution need not be extraordinary or special, unless the articles require it. The requisite meeting must be duly called and the appropriate resolution (ordinary, extraordinary or special, as provided by the articles) passed. (Section 50.) Notice of the increase of capital must be given to the Registrar of Companies within fifteen days of the passing of the resolution and the duty on such increase paid. The notice must give particulars of the classes of shares affected and the conditions subject to which the new shares have been or are to be issued. (Section 53.)

Section 55 of the Companies Act, 1913, provides that a company may, by special resolution, reduce its capital in any way, subject to confirmation by the court. After the special resolution has been passed by the company, a petition must be presented to the court for an order confirming the reduction. (Section 56.) The court may require the company to publish for the information of the public reasons and the circumstances which have led to the reduction. (Section 65.) The company is occasionally required to add the words "and reduced" to its name for such periods as the court may fix. (Section 57.) Where the reduction involves the extinction or reduction of the liability on unpaid capital, the position of creditors may be adversely affected, and they have the right to object. The court will require to be satis-

fied that the debts of the dissenting creditors are adequately provided for. (Sec. 58.)

An office copy of the court's order, accompanied by a minute (approved by the court) setting out the detailed particulars of the company's amended share capital, must be filed with the Registrar of Companies. The Registrar issues a certificate of registration of the court's order and the minute. (Sec. 61.) A copy of the minute must be included with every copy of the memorandum subsequently issued. (Sec. 62.)

### ✓ THE ARTICLES OF ASSOCIATION

The articles of association are the bye-laws, or the regulations, defining—

- ✓ 1. the duties, rights, and powers of the directors or managers as between themselves and the shareholders;
- ✓ 2. the mode of management of the company's business;
- ✓ 3. the rights and privileges of the shareholders individually.

(Whilst the memorandum contains the objects and powers of the company, the articles contain the regulations by which the objects and powers are carried into effect.)

From the nature of the articles it is clear that every company must have its "articles of association." For the convenience and guidance of the promoters the Companies Act gives model "articles of association" called Table A. A company limited by shares can adopt as its articles of

association Table A either wholly or with additions and alterations, or can have separate articles of its own. Usually a company has articles of its own, and they must include in the case of a public company, a number of regulations of Table A as given in Section 17(2) of 1936 Act while a private company must exclude regulations 78 to 82 (Act II of 1938).

Registration of articles is optional in the case of companies limited by shares, while it is compulsory for companies limited by guarantee and unlimited companies. When a company has articles of its own the document must be registered along with the memorandum and must also be signed by the subscribers to the memorandum. [Sec. 17 (1).] In the case of a company limited by shares if articles are not registered, the regulations in Table A shall be the regulations of the company in the same manner and to the same extent as if they were contained in duly registered articles. The term 'optional' has not been used in the sense that a company can be formed without "articles", because under Section 18 every company must have its articles. But when Table A is adopted by a company as its articles or automatically becomes the articles of the company by force of law, its registration is unnecessary and has been dispensed with. It is further provided that if the articles which have been registered are silent on some points, the provisions or regulations of Table A shall apply to those points unless the articles specially framed exclude or modify the regulations given in Table A. (Sec. 18.)

Both the documents—the memorandum and the articles—must be printed, divided into paragraphs numbered consecutively, and signed by each subscriber (address to be added) in the presence of at least one witness who shall attest

the signature. (Secs. 9 and 19.) Formerly only the articles of association had to be printed, but not the memorandum.

**Alteration of Articles of Association.**—Alteration in the articles of association of a company can be made by a special resolution, proposed at a duly convened extraordinary general meeting and passed by a three-fourths majority of those entitled to vote, and who do so vote in person or by proxy. Any alteration or addition so made shall be as valid as if originally contained in the articles, and be subject in like manner to alteration by special resolution. (Sec. 20.) But in no circumstances can the articles be altered to impose additional liability on any shareholder against his will. (Sec. 20 A.) The proposed alterations must not be in conflict with statute law, and should be within the scope of the company's powers as laid down by its memorandum. For example, a proposed article will be invalid if it declares that "the articles of the company are unalterable" since the power to alter articles is a statutory right conferred by Section 20 of the 1913 Act. Further, if the purport of any article or alteration is to extend the scope of the memorandum, it is invalid and *ultra vires*. Finally, all alterations must be *bona fide* for the benefit of the company as a whole. The rights of the minority are strongly supported by the courts, and any fraud or unfair treatment on a hopeless minority would be suppressed. A printed copy of the resolution must be filed with the Registrar, and every copy of the articles subsequently issued must contain a copy of the resolution.

**Articles and Their Relationship with Memorandum.**—It, therefore, follows that articles are subject to the memorandum and cannot give powers which are not conferred by the memorandum nor can they purport to create

rights which are inconsistent with the memorandum. The memorandum must be regarded as the chief document in matters which must, by statute, be provided in it. In other matters the memorandum must be read in conjunction with the articles, which may be used to explain or amplify it. In case of ambiguity or where the memorandum is silent on any point, the articles may serve to explain or supplement it. The provisions of the articles, however, cannot control or modify the terms of the memorandum where the latter is certain and there is no ambiguity in its meaning.

**Statutory Effect of a Company's Memorandum and Articles of Association.**—The statutory effect of the memorandum and articles is to bind the company and the members thereof to the same extent as if they had been signed by each member, and contained a covenant on the part of each member, his heirs, and legal representatives, to observe all the provisions of the memorandum and of the articles, subject to the provisions of this Act. (Sec. 21.)

It is important to understand the legal relationship between the company and its members, and also between the company and non-members. The company and its members both are bound to each other. The company can sue a member to enforce his obligations under the articles, e.g., payment of calls. Similarly, if the company disregards its memorandum or articles, a member can sue the company, e.g., in the case of an invalid forfeiture of shares. Between the company and non-members, no contract exists, because non-members are not parties to the memorandum and articles. The memorandum and articles, however, are public documents which can be inspected at the office of the Registrar of the Joint-Stock Companies of the province concerned, and persons dealing with the company are deemed to have notice



of their contents. For example, outsiders are required to know, or at least, they must find out, before they give loan to the company whether its directors have power to borrow money or not. If the articles of the company do not empower its directors to borrow from the public, the company shall not be bound to honour such loans. But where the directors have power to borrow and to bind the company, non-members are not bound to inquire whether all the prescribed steps have been taken. Suppose, for example, that the directors of a company have power to issue bonds if authorised by a resolution of the company. If the directors do not get the resolution passed and issue the bonds, still they become binding on the company, because creditors are entitled to assume that the required resolution was passed and that they could sue on the bonds.

**Effect of Registration.**—On the registration of the memorandum of a company, the Registrar shall certify under his hand that the company is incorporated, and in the case of a limited company that the company is limited.

From the date of incorporation mentioned in the certificate of incorporation, the subscribers to the memorandum, together with such other persons as may from time to time become members of the company, shall be a body corporate by the name contained in the memorandum, capable forthwith of exercising all the functions of an incorporated company, and having perpetual succession and a common seal, but with such liability on the part of the members to contribute to the assets of the company in the event of its being wound up as is mentioned in this Act. (Sec. 23.)

**The Statutory Provisions as to the use of the word "Limited".**—It has already been mentioned that

joint-stock companies can be established either by a special Act of the Governor-General in Council or by incorporating under the Companies Act of the country. In the former case a company with a limited liability is not required to use the word "Limited" at the end of its name, but in the latter case it is compulsory as is clear from the contents of the memorandum. The Imperial Bank of India and the Reserve Bank of India are examples of companies with limited liability formed to earn profits for its members and established by special Acts of the Indian Legislative Assembly in 1920 and 1934 respectively. These banks are not required to use the word "Limited" at the end of their names. This is true of the Bank of England. But the Local Government has the power to exempt a company from this requirement by issuing a license to that effect, provided it is satisfied that the company is to be formed for promoting commerce, art, science, religion, charity, or any other useful object, and intends to apply its profits (if any) or other income in promoting its objects, and prohibits the payment of any dividend to its members. (Sec. 26.)

People often have an erroneous idea of the term "and company" or its shorter form "& Co." used at the end of a firm name. It has no connection with the term "and Limited" or its shorter form "& Ltd." used at the end of the names of incorporated companies explained above and as required by Section 6 of the Indian Companies Act, 1913. The term "& Co." can be used by a partnership, a sole trader, or a joint-stock company. It is quite usual for persons in partnership to add on the expression "& Co." to the firm name, such as, Gajadhar Prasad Narayan Das and Co. It is not compulsory for a limited liability company to use the term "& Co.". For example, "Bharat & Co. Ltd." and

“Bharat Ltd.” are both correct. The term “& Co.” is not a representation of limited liability or incorporation, as the Companies Acts require the word “Limited” to be added where the business is carried on with limited liability. In other words “and Company” is not a technical expression, but “and Company, limited” is. The latter must not be used by any person or body of persons unless registered under the Companies Acts.

People often make mistakes in the use of the term “Messrs.” in addressing letters and envelopes. It should never be written before the names of a firm trading under an impersonal title, e.g., The Vulcan Iron and Co., The Daragunj Press, Ltd. It can be used in the case of firms and companies with personal names only. For example, Messrs. Narayan Das Gokul Das and Sons, or Messrs. J. and P. Coats, Ltd.

#### **What is meant by Membership of a Company.—**

A person becomes a member of a company if his name is registered in the company’s books as a holder of some portion of the stock or share capital. Section 30 of the 1913 Act provides that the signatories to the memorandum are deemed to have agreed to become members of the company, and on its registration must be entered as members in the company’s register of members. The section further provides that every other person who agrees to become a member, and whose name is entered on the register of members, shall be a member of the company.

#### **✓ Different Methods of Becoming a Member.—**

Membership may be acquired by one or more of the following methods:—

- ✓ 1. By being a signatory to the memorandum.
- ✓ 2. By application for and allotment of shares.

- ✓ 3. By purchase and transfer of shares, the transfer being subsequently approved and registered.
- ✓ 4. By transmission through death; lunacy or bankruptcy of a member.
- ✓ 5. By estoppel.
- ✓ 6. By acting as a director, whereupon he is deemed to have agreed to take up qualification shares.
- ✓ 7. By surrender of a share warrant to bearer.
- ✓ 8. By allowing one's name to remain on the Register of Members.

Executors or administrators of deceased members may become members by signing a "Letter of Request" when they become personally responsible for future calls on partly-paid shares with a right of recovery against the deceased's estate. Beneficiaries under a will accepting shares become members by signing a transfer, the executors acting as transferors.

Trustees in Bankruptcy or a Committee in Lunacy are members in a representative capacity only, and derive their authority from the order of the court. Most articles, however, authorise Trustees in Bankruptcy to be registered as a member in respect of the bankrupt's shares.

✓ **Estoppel.**—A member who has disposed of his shares, yet knowingly allows his name to remain on the register, is "estopped" from denying that he is a member and is responsible for the liabilities of membership.

**Who can become Members.**—A corporation or a limited company can become a member of another company. It is doubtful whether a firm can become a member, as it has no legal existence apart from its partners. In India a minor cannot enter into a contract, and a membership of a joint-

stock company requires that one must have an agreement with the company, and this a minor cannot do. He, therefore, cannot be a member of a joint-stock company.

✓ **Consent of Directors.**—A person cannot be appointed a director or advertised as a proposed director of a company, unless, before the registration of the articles, he has signed and filed with the Registrar a consent in writing to act as such. [Sec. 84 (1) (i).]

✓ **List of Directors.**—Along with the application for registration of the memorandum and articles of a company the applicant shall file with the Registrar a list of persons who have consented to be directors of the company. The list must not contain the name of any person who has not given his consent in writing. [Sec. 84 (2).] ‘Consent of Directors’ and ‘List of Directors’ are not required of private companies.

**Contract by Directors.**—A director has either to sign and file with the Registrar a contract in writing to take from the company and pay for his qualification shares (if any), or sign the memorandum and write against his name the number of shares not less than his qualification (if any). [Sec. 84 (1) (ii).] It is thus clear that ‘contract by the directors’ is not required where directors subscribe their signature to the memorandum and write against their names the number of shares taken, which must not be less than the qualification shares. ~

**Declaration of Compliance.**—A declaration by an advocate, attorney or pleader entitled to appear before a High Court who is engaged in the formation of the company, or by a person named in the articles as a director, manager or secretary of the company, that all the requirements of the Indian Companies Act, 1913, in respect of matters precedent

to registration of the said company and incidental thereto have been complied with shall be filed with the Registrar, and the Registrar may accept such a declaration as sufficient evidence of compliance. [Sec. 24 (2).] He then issues a certificate of incorporation.

**Issue of Prospectus and Allotment.**—After receiving the certificate of incorporation a public company has to prepare a prospectus, file it with the Registrar, and then it is issued to the public inviting the investors to subscribe the shares of the company. The prospectus must be dated, and the shares must be allotted within 180 days<sup>4</sup> from the date of the prospectus. But the directors are not to allot any share capital offered to the public, unless the minimum amount stated in the prospectus, reckoned exclusively of any amount payable otherwise than in cash, has been subscribed and 5 per cent thereof received in cash by the company. [Sec. 101 (7).] If a company does not issue a prospectus it must file with the Registrar a "Statement in lieu of Prospectus". [Section 103 (1) (d).] It is a document containing in brief all the information given in a prospectus.

**Restrictions on Commencement of Business.**—Within a month of the allotment, a Return of Allotments<sup>5</sup> must be filed with the Registrar with a Statutory Declaration<sup>6</sup> by the Secretary or one of the directors of the company that:—

1. Shares held subject to the payment in cash have been allotted to an amount not less than the minimum subscription.
2. The directors have paid the amounts due on

<sup>4</sup> Indian Companies Act, 1913, Section 101 (4).

<sup>5</sup> Indian Companies Act, 1913, Section 104.

<sup>6</sup> Indian Companies Act, 1913, Section 103(1)(c).

application and allotment on their qualification shares, according to Section 103 of the Companies Act, 1913.

3. In case the company has not issued a prospectus, a statement in lieu of prospectus has been filed with the Registrar.

The Registrar then issues the certificate entitling the company to commence business. A private company is not permitted to issue a prospectus nor has it to file Statement in lieu of prospectus or a statutory declaration. [Section 103 (6).] Immediately after receiving the certificate of incorporation, a private company is entitled to commence its business and to exercise borrowing powers.

**Registered Office of the Company.**—A notice of the situation of the registered office of the company must be filed with the Registrar any time within 28 days from the date of incorporation of the company. But it is advisable, when possible, to file this notice along with the other documents mentioned above. (Section 72.)

## Section 2—Prospectus

A prospectus contains information giving clearly the reasons why the promoters are of opinion that the proposed company is expected to be successful and to earn good profits for its shareholders. The prospectus must be dated and signed by all the directors or by their agents authorised in writing. It must be filed with the Registrar of Companies on or before the published date, and no copy of it should be issued to the public till then. On the face of every copy of the prospectus must be stated that it has been filed with the Registrar. (Section 92.)

When a producer desires to sell his products, he must first inform the buyers about it, that is, bring to the notice of the consuming public that the commodity is for sale. He must also convince them of the utility and the advantage of purchasing it. The more the people will come to know of it, the greater will the demand be, and if it is really very useful, the demand will naturally increase very much more. In the same way, when a company is formed, it must first be brought to the notice of the investing public, and it will then be necessary to convince them that the management will be good and efficient because the persons who have been proposed as directors and managers of the company have already established their reputation for honesty and efficiency, that the company is sure to do well and will earn good profits for its shareholders, and that it will be to the advantage of the investing public to purchase the shares of the proposed company.

The question naturally arises as to how to bring it to the notice of the public that a new company has been formed



## PROSPECTUS

and its shares are for sale. This can be done by advertising the prospectus of the company in newspapers, by sending circulars to specially selected persons who may reasonably be expected to be prospective buyers of shares, and by inviting them to subscribe or purchase its shares and debentures. But the advertisement is not an end by itself. It is a means to an end. Its purpose is two-fold: firstly, to attract the attention of the readers to the prospectus advertised so that people may know that a new company has been formed; secondly, to convince those who have surplus money that the proposed company will earn good profits and, therefore, it will be to their advantage to purchase its shares. Every day so many advertisements appear in the daily papers, but how many of them really attract our attention and how many of those that attract do we care to read in order to know and to find out what they are?

People read daily papers for the sake of news, but all are not interested in every kind of news, and few have the time and the patience to read the whole of it, not to speak of looking at the advertisements. The usual practice is to glance over the headings of news and to read in detail only those portions which may interest individual persons. People turn the pages of the newspaper never paying much attention to the advertisements therein. But when an advertisement covers the whole page or at least half of a page, it is certain to attract the attention of the readers. It is true that the space occupied by an advertisement is a factor in its cost. The more the space occupied the greater is the cost. But in the case of a prospectus a large space is necessary because of the information which it must contain for the prospective buyers of shares. Even in those cases where an advertisement by itself does not require a large space, a

whole-page advertisement is useful and paying in spite of its cost.

To draw the attention of the readers to the advertisement is not enough. It is necessary to create sufficient interest in the minds of the readers, particularly of investors, to induce them to read the detailed information given in the prospectus, so that they may be convinced of the desirability of purchasing its shares. To make the advertisement serve its purpose one must know how to create this interest in the minds of the readers. Then only will they care to read the whole of it before they can decide to purchase its shares or not. This can be found out easily by putting oneself in the position of an investor. What the investor wants is the safety of his principal and adequacy of its return and these depend upon the prospects of the company, in other words, upon its profit possibilities. The success and the income of a company depend upon the choice of the industry, its location, competition with other producers, adequate supply of raw materials and their sources, availability of experts and the supply of skilled labour and finally on the honesty and efficiency of the management. Of all these factors the honesty and efficiency of the management are the most important ones to inspire confidence in the minds of the public about the future success of the proposed company. A company is managed by its directors. It is, therefore, necessary that the proposed directors must be persons in whose efficiency and honesty people will have confidence, so that they may be certain that the company will be in safe hands. Prospective investors are naturally inquisitive to know who the directors are and it is their names that will create interest in the minds of the purchasers of shares. The list of the directors should, therefore, be given a prominent position in the prospectus to enable

the readers to find out the names easily and without delay.

The promoters must have these factors in mind while preparing the prospectus. Often promoters are found to assert in the prospectus that the company will be successful and that it is sure to earn large profits without giving adequate reasons for their conclusions. This kind of assertion unsupported by reasons or facts and figures can never persuade the investors to purchase the shares of the company. On account of this lack of response to buy shares in large quantities the investing public is often blamed for not being industrially minded. It is certainly not the fault of investors nor is it an accurate statement that investors are not industrially minded, because it has often been found that companies promoted by known and reliable parties sell shares of their companies very easily and quickly. It may be possible that sometimes good ventures have been lost for want of adequate support from the public. It is also possible that faulty and inadequate information in the prospectus may be due to the ignorance of the promoters. All the same, in a majority of cases the promoters are to be blamed. It is their duty and responsibility to convince the public and if they fail in their task they have no right to blame others.

Statutory regulations require that a prospectus should contain certain information. We shall discuss all these and a few more to indicate the precaution and care a promoter should take in its preparation, and also the way an investor should scan and analyse a prospectus to determine whether or not to purchase the shares of a company.

**1. The Name of the Company.**—Sometimes some people have a better knowledge of certain industries or trades and they prefer to purchase shares of companies carrying on

those trades or business. In order to create interest in the minds of the maximum number of investors it will be better if the name of the company clearly shows the nature of the business.

**The Capital.**—The memorandum of association contains a statement of the amount of capital of the company and its subdivisions. This must be given in the prospectus also as it is necessary to include in it the contents of the memorandum.

The capital of a company is divided into units called shares. A company takes permission to sell shares up to a certain maximum amount and the total face value of all the shares is called *Authorised Capital*, and it is on the amount of authorised, nominal or registered share capital that the stamp duty has to be paid at the time of the registration of the company. The scale of the stamp duty is given at the end of this chapter. It is not necessary that the company must sell all its shares and the value of the shares which is offered to the public to subscribe is called *Issued Capital*. People may not purchase all the shares offered to them and the value of the shares which they buy is called *Subscribed Capital*. Usually the directors of a company do not ask the subscribers to pay the whole amount at once, but direct that a portion of each share shall be paid on application, a further portion on allotment, and other portions in a series of calls at later dates. The value of the shares so called up by the directors on shares allotted is termed *Called-up Capital*, the balance remaining at call, the *Uncalled Capital*. Sometimes shareholders fail to pay their instalment and the actual money received is called *Paid-up Capital*. A limited company may by special resolution determine that any portion of its share capital which has not been already called

up shall not be capable of being called up, except in the event and for the purposes of the company being wound up. This is the reserve liability of limited company and the portion of the capital so earmarked is called *Reserve Capital*. Reserve capital is also uncalled capital but the difference between the two is that the latter is subject to call by the directors while the former is not. There is a difference between a reserve capital and a reserve fund. Reserve fund is built out of profits and is specially earmarked for use in emergency or for expansion of the business. It increases shareholders' money in the company but it is not a part of share capital. The initial *Working or Circulating Capital* of the company is the amount of money remaining in the hands of a company after all expenses incidental to the establishment of the company and the purchase of its fixed assets have been met together with the surplus of any floating assets that may have been acquired over liability to creditors.

The subscribers may be asked to pay the whole amount of the share money at once, as it was done in the case of the Reserve Bank of India, or, as is usually done, they may be required to pay in instalments. The amount of each instalment is fixed beforehand. The first instalment, called 'application money', is paid along with the application: the second, called 'allotment money', when the directors allot shares to the applicants; and the subsequent ones termed 'calls' are to be paid as the directors decide from time to time.

The method of collecting capital in portions has a distinct advantage as it enables many people to purchase shares of a company and also because each shareholder can purchase in larger quantities, which will not be possible for

many of them if for each share purchased the whole amount has to be paid at once. It also democratises investments, otherwise it will practically be a close preserve of the rich. The same purpose may be achieved by making the face value of the shares low. In India the value of shares is usually Rs. 10, Rs. 50 or Rs. 100; but in a majority of cases it is Rs. 100. The company has no use for the whole money at once, nor can it be utilized till the allotment has been made and a certificate to commence business has been obtained from the Registrar. [Section 101 (2B)]. It is thus obvious that the application money need not be large. It must be at least 5 per cent of the face value. Usually for a share of a face value of Rs. 100, it is Rs. 10, the allotment money is Rs. 15, and each call is of Rs. 25. There is no statutory minimum for 'allotment' money and 'calls'. It is desirable to have a minimum interval between the allotment and the first call and then between the 'calls'. This will permit the investors to apply for more shares because they will get time to collect the necessary amount of money for the next instalment.

### THE BOARD OF DIRECTORS

A company is managed by its directors elected by the shareholders from amongst themselves at the annual general meetings. There is no maximum limit to the number of directors that a public or a private company can have. Section 83 A, however, makes it compulsory for a public company to have at least three directors, though a private company may have two, one or none at all. According to Regulation 95 of Table A which is compulsory for both

public and private companies, dividends are to be declared by a company in the general meeting, but no dividends shall exceed the amount recommended by the directors. This creates a difficulty in the payment of dividends in the case of a private company which has no director. Therefore, indirectly and for all practical purposes, it is necessary for a private company to have at least one director.

It has already been stated above that a company is managed by its directors elected by its shareholders from amongst themselves at the annual general meetings of the company. But before the first ordinary general meeting of the shareholders can be called, a lot of preliminary work of the company has to be done, which can be carried out only by the directors of the company. To bridge the gap the Companies Act has provided for nomination of the directors by the promoters of the company for the intervening period. Besides, business expediency requires that the proposed directors should be given an opportunity to justify their selection; they should, therefore, be given a reasonable time to prove their merit. At the same time, shareholders should also be given time to form a judgment about the efficiency of these directors. For these reasons law has provided that the proposed directors should continue in office for at least one financial year, that is, till the first annual general meeting. These directors resign or automatically cease to be directors of the company before the first ordinary meeting of the shareholders, termed the Annual General Meeting, which is held after one year and before 18 months from the date of incorporation as is laid down in Section 76. In this meeting the shareholders elect the directors, and usually those very persons are elected who acted as directors during the intervening period. If the same men are elected

directors, it becomes necessary for the promoters to propose the names of only those persons who have experience of business and have established a reputation for efficiency and honesty in managing business concerns. This is the reason why the list of the proposed directors in the prospectus is so very important, because it is on the efficiency of the directors that the success of the company depends.

Not very long ago most of our directors were titled persons, rich landlords or zamindars or lawyers. A few such cases may be found even now as an inheritance of the past. But we need not be ashamed of it as something unusual. The history of joint-stock companies in America, England and other European countries proves that in India history has only repeated itself.

We often derive benefit from the experiences of others but there are certain matters in which any amount of experience or knowledge of the experiences of others does not help us to avoid the losses and sufferings which people in other countries have suffered and have overcome. People in every country have to go through the mill. Company organisation and management is one of those instances in which little benefit can be derived from previous experience. In the early days of joint-stock company organisations in England, directors were selected from amongst the landed aristocracy. Wealth, education and experience in management are the three important requisites to qualify one for selection as a director of a company. In those days wealth and education were confined to the rich and the upper middle classes, while the majority of the people were poor and had little or no education. The choice lay between the aristocracy and the upper middle classes. The educated men of the upper middle classes who belonged to one pro-



fession or the other, such as engineering, medicine, law, etc., were very busy men, had no time to spare, and regarded business management as something foreign or alien to their profession, culture and education. People in general regarded the rich landlords as superior beings on account of their knowledge, intelligence, education, ability and particularly for their social and political status. They inspired confidence in the minds of the people. Moreover, promoters found that to sell shares in large quantities, enlisting the support of rich landlords was necessary. Consequently, circumstances compelled them to select most of the directors from this class. In course of time, the failures of companies due to mismanagement and inefficiency showed that the landed aristocrats were not always fit persons to manage business concerns. Gradually, men of the legal profession began to take interest but they too did not prove much of a success. But with the growth of the business and the development of joint-stock companies, people realised that business experience was essential to make one an efficient director and that only efficient businessmen should be appointed directors, and in course of time a large number of able, experienced and educated businessmen were available.

History in America is not different. Being a new country, she naturally started to develop her industries on a joint-stock basis long after England. America had no hereditary landed aristocracy and directors of early joint-stock companies were mostly from the legal profession, and in course of time were replaced by businessmen themselves, as was subsequently done in England. Apparently it seems that she could have avoided the losses which business concerns in England had suffered on account of inefficient directors. But this was not possible. The reason is obvious.

It takes time for business to develop and for men to get the requisite business experience to become efficient managers and directors. Consequently, promoters have no choice but to appoint non-businessmen as directors in the early stages of joint-stock company formation in a country.

In the selection of directors, two more factors are to be borne in mind, *viz.*, the time the selected persons will be able to give to the services of the company, and the distance they will have to travel or the time they will need to attend meetings. However able and efficient a man may be, it is no use appointing him a director of a company if he has little or no time to attend regularly the meetings of the board. It is much better to appoint a second rate man who has enough time to devote to the affairs of the company than a first rate man with little or no time to spare. Apart from this, the existence of the absentee directors may lead to a monopoly of power in the hands of one or two directors only. The meetings are usually held at the registered office of the company, and the distance which the directors have to travel and the time it takes to attend the meetings of the board of directors are important for two reasons. Firstly, if the distance is long, it may not be possible for them to attend meetings regularly. Busy men may be able to spare one or two days in a month or so to attend a meeting, but not more. Secondly, the longer the distance, the greater will the cost be. Once a gentleman brought to me a prospectus of a company at a town in Northern India. Of the five proposed directors three were from long distances. One was from Bombay, another from Calcutta and a third from Lahore. efficient and capable businessmen are usually too busy to attend meetings at a great distance. They do not like to attend meetings at a place requiring more than a night's

journey. If they are not very able men, it is a waste of money for the company to spend such large sums on their travel, when equally capable men may be available near about. Most of the top businessmen in India either themselves act as promoters or have large stakes in the companies of which they become directors. Usually the registered offices of these companies are at a commercial centre where most of the directors reside. This eliminates or reduces to its minimum the need of travel by directors and, therefore, they can manage to attend meetings of several companies. In conclusion it can be said that in selecting directors the promoters must bear in mind the following factors:—

1. The persons proposed must be businessmen with sufficient experience and, if possible, reputation.
2. They must have sufficient time to devote to the work of the company.
3. They must not be residents of places far away from the registered office.
4. They must have sufficient stake in the prosperity of the company.
5. The address and the official designation of each director should be given against his name in the list of directors.

In India the number of directors of a company is usually between five and seven. Five are good enough. Too many directors, instead of increasing the efficiency of the board, may only increase the cost to the company.

But in the case of a business of a special nature, such as the central bank of a country, it may be desirable in the interest of the country and also of the business itself to have

in its directorate representatives of the important businesses, economic and other sections of the country to inspire confidence in the minds of the public. To accommodate the different interests, it may be necessary to have a few more directors but in no case should the number be unwieldy or more than the circumstances of the situation require.

**Minimum Qualification of Directors.**—The Companies Act does not lay down the minimum number of shares one must hold in one's name to be eligible for election as a director of a company. For this reason, it may be possible for even the owner of only one share to be elected a director. A company, however, can make rules and regulations for its members and these are embodied in the articles of association of the company requiring a shareholder to own in his right a minimum number of shares as a necessary qualification to become a director. Practically every company has this regulation in its articles. It is based on the principle that responsibility and risk should go together, meaning that no one should be given the responsibility to manage a business unless one would assume a certain amount of risk. For there is the possibility that without risk even a very able and efficient man may be tempted to become speculative, which may put the company to a serious loss and may result in its failure. The more shares a person owns, the greater will be the risk of loss to him in case the company fails. He is, therefore, likely to be very careful and cautious in his management. In the circumstances it will be desirable to make it compulsory for directors of a company to own a minimum number of shares, which may be called the minimum qualification. The question is what this minimum should be.

If a company decides in favour of a high minimum qualification, the election of directors will naturally be confined to a few rich men only. Again, if we bear in mind the principle of investment, *viz.*, diversification of investments, that is, distributing one's investment in different industries and in different companies, one must be very rich in order to buy a large number of shares in one company so as to maintain diversification of investments. This will further narrow down the sphere of choice in the selection of directors. But there is also another side to the question. Wealth or property is not synonymous with ability or efficiency. A man may be rich but not necessarily able or efficient, and without efficiency risk alone cannot enable a man to manage a business successfully. There are many able men in communities which are not wealthy and there is every likelihood of the business prospering in their hands. The constitution of a company should not be such as to exclude these men from becoming directors. Risk and ability are, therefore, the two factors which should be taken into consideration in choosing directors and in determining their minimum qualification. A very high minimum qualification is not desirable in the interests of the company itself, but it is equally important that directors should bear a reasonable amount of risk to create responsibility in them. Besides, risk is a relative term. To a man of moderate means Rs. 5,000 may be as valuable as Rs. 50,000 or Rs. 100,000 to a very rich person. A risk of Rs. 5,000 can make the former feel as responsible, or even more so, compared to a rich man with twenty times its value. For all these reasons the minimum qualification should be within the reach of many able, efficient and responsible persons of moderate means so that they may be eligible for election as directors. At the same time it should

be enough to make one feel responsible and cautious. The consensus of opinion is that ordinarily it should not be less than Rs. 5,000 and more than Rs. 10,000 according to the capitalisation of the company.

**Underwriting.**—By underwriting is meant the contract the promoter makes with an individual or a firm of underwriters, the latter undertaking to sell the whole or part of the share capital of the company issued to the public at a certain rate of commission.) The underwriters give an undertaking to sell the shares within a certain date. If they fail to do so, the balance of the unsold portion of shares is taken or subscribed by the underwriters themselves, till they are sold to the public. The promoters do not have to worry nor have they to incur any extra expense in connection with the sale of share underwritten. If brokers are engaged, the underwriters do it and pay for them. It is always desirable to mention in the prospectus the amount of shares the directors, their relations and friends have applied for. It will go a long way to create confidence in the minds of the public that the project is well thought out and genuine and that in all likelihood the company is sure to succeed. It is, therefore, obvious that for the portion of the share capital for which sale has already been arranged no underwriter need be engaged and no commission need be paid to him. The promoters should arrange for the underwriting of shares actually offered to the public, that is, the total amount issued, less the amount applied for by the directors and others. In no circumstances should they pay any underwriting commission for which sale has already been arranged. In India there is no underwriting house worth the name for underwriting shares and debentures of joint-stock companies. Shares are usually sold through the efforts of the promoters, managing

directors or managing agents as the case may be. They sometimes engage the services of brokers to sell the shares to the public. (A broker is different from an underwriter. He gives no undertaking and receives commission on the amount of shares he sells.) Of course the rate of commission paid to a broker is very much less but he takes no risk. Sometimes a higher commission is paid to a broker who guarantees a minimum sale. But he too does not give an undertaking similar to the one given by the underwriter who takes the responsibility of selling the whole amount underwritten and failing to do so he himself takes the balance unsold; while the broker guaranteeing a minimum sale does not take the balance. He either forfeits the whole of his commission or is paid at a lower rate for the amount sold by him. A company never pays underwriting as well as brokerage commission for the same shares. Of course, if only a part of the shares has been underwritten and the other part is being sold by the promoter himself, he may engage brokers and pay brokerage commission to them for this part only. ¶ It is always desirable to mention the rate of commission in the prospectus. ¶ I have come across the following statements in a prospectus:—

(a) that the entire issued capital has been underwritten at, say, 3 p.c. commission;

(b) that the friends and relations of the directors have applied to take so many shares which will be allotted in full;

(c) a brokerage commission will be paid at  $2\frac{1}{2}$  p.c.

There are obvious fallacies in the above statement. If the entire issued capital has been underwritten, the promoters have no longer any responsibility to arrange for the

sale of its shares, much less to engage brokers and to pay them for their services. If brokers in this case are to be engaged, it should be done by the underwriters and they should pay for them, and not the company or its promoters or directors. (Again, underwriters are paid for their efforts and services in arranging the sale of the shares.) If out of an issued capital of 10 lacs of rupees the directors, their friends and relations have agreed to subscribe shares worth 2 lacs, it is clear that the underwriters will have to arrange for the sale of the remaining 8 lacs. The underwriting agreement shall be for 8 lacs of rupees only and they should be paid a commission on this amount and not on the entire issued capital of 10 lacs of rupees. It is possible that the intention of the promoter was to engage underwriters and to pay them a commission on 8 lacs of rupees only. If so, there is all the more reason to be very precise in the preparation of a prospectus so that no doubts or ambiguity may be left in the minds of the prospective buyers of shares.

According to Section 93(ee) of the amended Act of 1936 it is now necessary to give the names of the underwriters in the prospectus when shares or debentures are underwritten. The directors are also required to give their opinion that the resources of the underwriters are sufficient to discharge the underwriting obligations.

**Objects of the Company.**—Both in the prospectus and in the memorandum of association, the objects of the company are to be stated and discussed; but there is a very great difference between the object clauses in the two documents. The memorandum of association being only a charter of the company the purport of its object clause is to state all possible activities which the proposed company may take up now or in the near future. It, therefore, contains the list



of activities only. A prospectus, on the other hand, is an advertisement to sell shares and debentures of a company and must contain convincing reasons, with data if possible, showing why it will be to the advantage of investors to purchase its securities.

The aim with which the object clause in the prospectus should be written is to remove all doubts and suspicions from the minds of the investing public, thereby convincing them that the company is sure to earn good profits. With this aim in view, all necessary information should be given in the prospectus, which guided the promoters to arrive at the above conclusion. They should show that there is a demand for a company of this type, that plenty of raw materials is available or can be procured easily and at a reasonable price, that there is no dearth of experts and skilled workmen and finally, that the cost of production will leave sufficient surplus as profits to the company.

Promoters are often found to assert the success of a company and the prospect of its earning a large profit without giving adequate reasons for their conclusions. Sometimes the figures that are given in support of their contention appear on their very face to be imaginary, at least not convincing. In the circumstances the public cannot be blamed for not purchasing shares in large quantities. For this lack of response the promoters are really responsible and they wrongly blame the investors for not being industrially minded.

**Minimum Subscription.**—From the time of the incorporation of a company till the allotment of shares is made and the certificate to commence business is obtained, the promoters or the proposed directors of the company have to do a lot of preliminary work and

incur expenses for stationery, printing, stamp duty, legal and registration fees, lease or purchase money to the vendors, if any, office establishment, etc. Till the shares are allotted the company cannot use the application money which according to Section 101 (2B) must be kept in deposit at a scheduled bank as defined in the Reserve Bank of India Act, 1934, until returned if no allotment is made or until the certificate to commence business is obtained. Consequently, the promoters or the directors themselves have to pay for all these expenses during the intervening period in anticipation of receiving it back from the company after it has obtained the certificate to commence business.

Every company requires a certain minimum amount of capital to begin its business, without which it cannot be started and, if started, is bound to fail within a short time. If people have not applied for a sufficient number of shares to cover this minimum capital requirement, the directors should not allot shares to the few applicants and should return their application money. If shares are not allotted, the expenses incurred for the company till then shall fall on the promoters themselves. People are usually actuated by self-interest and in the absence of any restrictions the promoters are tempted to allot shares to the few applicants knowing fully well that the work cannot be started and that the company is sure to go into liquidation, maybe almost immediately. Experience has taught the desirability of protecting investors against inexperienced and fraudulent promoters and the necessity of adopting measures to prevent the latter from allotting shares so long as the minimum capital required has not been subscribed.

There can be no hard-and-fast rule about the amount of minimum capital which a company must raise and with-

out which the business cannot possibly be started. The Government is very shy to restrict the freedom of individual persons and associations. In the old Act companies were, therefore, required to state the amount of the minimum subscription entrusting individual investors to judge the adequacy of the amount so fixed by the promoters of a company. The experience of more than twenty years both in England and in India has shown that most of the investors being only laymen cannot judge properly in these matters. As a matter of fact it is not easy even for those who know something about business to judge correctly because these matters are very complicated and depend upon so many factors which vary from industry to industry and in the same industry from company to company. Hence there can be no golden rule to calculate the minimum capital of a company. However, provision has now been made in Section 101(2) of the new Act (1936) according to which the minimum subscription should be enough to cover the expenses for the following:—

- (a) the purchase price of any property purchased or to be purchased;
- (b) preliminary expenses and commission on sale of shares;
- (c) repayment of any moneys borrowed for the above purposes;
- (d) working capital.

If the provision of this section is analysed, it will be found that it does not give any real protection to investors. The Act requires that the directors must raise sufficient share capital to provide for the items mentioned above; but it is left to the opinion of the directors themselves as to what

this amount should be. They are not required to give even the amount of each item, though by itself it will be of no use unless certified by the auditor of the company that all the figures are authentic and correct. This will mean no hardship to the directors. The price or cost of some of the items is already known to them, and only in two cases calculations may be necessary. The price which has been agreed upon to be paid to the vendors for the property already purchased, preliminary expenses, and commission on sale of shares, and repayment of money borrowed for these purposes are either known or can be easily calculated. The construction of buildings, the purchase of machinery and the amount of working capital are items which require careful calculation. These calculations the promoters have always to make in order to determine the authorised capital, issued capital and the minimum capital required to begin the work on a satisfactory basis. The estimate of the contractor, the price quotations of the machine manufacturers together with the prices and the estimated expenses stated above will give the minimum amount of fixed capital required. If it is a manufacturing concern, the amount of working capital will depend upon the minimum amount of daily production, and, therefore, on the cost of raw materials to be kept in stock, the value of semi-finished articles in the course of production, and the price of finished goods which on an average will remain unsold in the stock. One can easily calculate at least approximately the amount of working capital and by adding it to the minimum fixed capital one can determine the minimum capital required by a company. If it is desired that Section 101(2) concerning minimum subscription should fulfil its purpose the directors should be required to disclose all these figures, get them certified by the auditor of the com-

pany and to file it along with the prospectus with the Registrar of Joint-Stock Companies. It is only then that people may be expected to have some confidence in the ability, efficiency and honesty of the promoters.

When a prospectus is issued, the 'minimum subscription' must be stated in the prospectus alone, and not in the memorandum or articles. In case a prospectus is not issued and in its place a 'statement in lieu of prospectus' is filed, the amount of minimum subscription must then be fixed by the memorandum and the articles and should also be stated in the statement in lieu of prospectus. If no amount is so fixed and named, the whole amount of the share capital issued to the public shall be deemed to be the 'minimum subscription.' [Section 101(7).] The restriction about the minimum subscription is not applicable to a private company.

**The Management.**—A company is managed by its directors, but the function of management is divided into two parts. The directors lay down the principle or the policy, appoint a manager and other executive heads, and supervise and control all the activities of the concern. The manager is the chief executive head and is responsible for carrying out the policy and the instructions of the board of directors in the day-to-day work. It is, therefore, clear that the success and profits of a company depend not only on the efficiency of its directors but also on its manager. Purchasers of shares naturally would like to know not only the names of the proposed directors, but also, how the company will be managed and who has been appointed its manager, that is, the chief executive head. There are three methods of managing a company, *viz.*, (1) by an employee manager; (2) by a managing director or directors and (3) by managing agents.

In India companies, particularly the manufacturing concerns, are generally managed either by a managing director or directors, or by managing agents. The name of the party is always given in the prospectus to inspire confidence in the minds of investors. According to Section 93(1) (c) it is necessary to give the names, descriptions and addresses of the managers, or proposed managers and managing agents or proposed managing agents (if any) and any provision in the articles or in any contract as to the appointment of managers or managing agents and the remuneration payable to them. The significance of each of the above types of management will be discussed in another section of this chapter.

**Agreements.**—Promoters often arrange for the purchase of an outgoing concern. On behalf of the proposed company they enter into an agreement with the owner of the property to purchase it at a certain price and on certain conditions. Any contract made for a company before the date on which it is entitled to commence business shall be provisional only, and shall not be binding on the company until that date and on that date it shall become binding. [Section 103(3).] Before people purchase shares of a company, they would like to know the nature of the property, the price agreed to be paid and all relevant information concerning the agreement in order to decide the desirability of purchasing its shares. The promoters must give in the prospectus convincing reasons that the price agreed to be paid for the property is reasonable and that the company will derive a distinct advantage by its purchase. The names and addresses of the vendors of any property purchased or proposed to be purchased must be given in the prospectus. [Section 93(1) (f).] It is also necessary to mention whether the vendor is to

he paid the whole amount in cash, or in shares, or both in cash and shares, and where the payment is both in cash and shares the amount of payment in cash and shares should be given separately, and also the amount (if any) payable for 'good-will'. [Section 93(1) (g).]

If the property purchased or proposed to be purchased by the directors has within the two years prior to the issue of the prospectus been transferred by sale, the amount paid by the purchaser at each such transfer should be given as far as the information is available. If the property is a business concern, the profits earned by it in each of the last three years preceding the issue of the prospectus, or during each year of the existence of the business if it is less than three years old, should be given. It is also necessary to append to the prospectus a balance-sheet of the business concerned made up to a date not more than ninety days before the date of the issue of the prospectus. [Section 93(1) (ff).]

There may be other kinds of agreements also, such as, a lease of land or property; the purchase of machinery on a royalty basis; the management of the company by one or more directors as a managing director or managing directors, or by a firm of managing agents and the remuneration payable to them. In every case the dates, parties and the chief conditions of the agreements should be disclosed and also the place where the copy of the contract may be inspected. [Section 93(1) (l).]

**Directors' Interest.**—It is possible that the promoter or some of the directors may be interested in the promotion of the company for two reasons (1) to sell or to lease to the company a property owned by them, (2) one or more of the directors may be appointed in the company as its managing director or directors, or in some other capacity with high

emoluments. The property may be a losing business concern or a worthless one and the directors to be appointed as managers may not be very efficient and may not have enough experience. It is equally possible that the property may be worth acquiring and the directors to be employed in the company may be very efficient and the company may be very lucky in obtaining their services. The fact that the directors are personally interested in the promotion is no proof of the worthlessness of the proposed company. In order to remove suspicion from the minds of, and to disarm all opposition from, the investing public, it is better to disclose the facts of the various agreements for the information of the investors and leave it to them to judge the merits of such agreements.

**Remuneration of Directors.**—The directors of a company are usually paid a fee for attending each meeting of the board of directors and also their travelling expenses. These are governed by the articles of association of the company. There is a company in India which does not pay any fees to its directors, not even their travelling expenses. The fee paid to the directors varies from company to company but usually it is Rs. 100 for each director for each meeting. There are instances where it is as high as Rs. 200, while in others it is Rs. 50 or even Rs. 25. In England and in America the scale of fees is very much less. It is roughly £ 1 and ten dollars respectively for each meeting, the latter sum being normally equivalent to two pounds. The fees for directors in India are obviously very high and the sooner they are reduced the better. It should not be a source of income to them. For reasons already explained, it would be better to have as the directors of a company all local men, that is, persons residing as near the registered office of the company as possible.



**Preliminary Expenses.**—Till the allotment of shares is made and a certificate to commence business is obtained from the Registrar, all the expenses for the registration and incorporation of the company are paid by the promoter or the proposed directors.<sup>1</sup> These expenses called “preliminary expenses” are formally accepted and passed by the shareholders at the Statutory Meeting of the company. In addition to this, promoters are often paid a certain amount of remuneration, which is also included in the preliminary expenses, for conceiving the idea and for their trouble and services. In India most of the companies, other than banks, are managed either by managing directors or by managing agents. When a company is formed the promoters usually advertise that no preliminary expenses are to be paid to the promoters for the services, implying thereby that the proposed company will not be burdened with this expense. It is not so simple as it appears at the outset nor is it an accurate and adequate statement of the true state of affairs. One or more of the directors may be appointed to manage or may be interested in the management of the company either as managing directors or as managing agents, for which they are paid annually a very high remuneration. This by itself may be considered sufficient and adequate compensation for their trouble and service. It may be said that this payment is for the work they do for the company and the company has to pay somebody for the management. This payment, therefore, is not for nothing. In India there is no underwriter of joint-stock companies in its true sense. The company, therefore, engages the services of brokers and pays them commission

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<sup>1</sup> Indian Companies (Amendment) Act, 1936, Section 101 (2B).

for the sale of shares effected through them. The managing directors or the managing agents, as the case may be, are also paid brokerage commission for the sale of shares arranged by them. They are paid commission not only on the shares they sell to outsiders, but also on the amount subscribed by them, their friends and relations, and sometimes also on shares applied for directly by investors as a result of advertisement. Our information is that many of them charge commission even for the sale of shares arranged by brokers. What they really do is that they charge a full rate of commission and pay at a lower rate to the brokers and keep the balance as their profit. This is usually a great source of income to the promoters, much more than the amount ordinarily paid to them as preliminary expense. The Act of 1936 now makes it compulsory for a company to declare and to show in the Statutory Report the amount of commission paid to the manager or the managing agents. This alone cannot stop the mischief because the new Act does not prevent them from taking commission. In case the directors and managers do not like people to know the amount of commission earned by them, they can easily earn it in the name of someone else. Commissions are paid to brokers and others for the efforts they make and the services they render to procure investors to purchase shares of the proposed company. No commission need, therefore, be paid to any one for shares applied for directly as a result of advertisement because nobody has made an effort or rendered any service in the sale of such shares. Further, the promoters often mention in the prospectus that so many shares have been applied for by the directors, their friends and relations in order to convince the investing public that the proposal is genuine and sound and that the company is sure to do well.

If it were not so, the promoters and their friends would not take the risk of purchasing so many shares. Evidently no effort has been made by any one to induce the directors, their friends and relations to purchase shares. It is urged that the promoters and the directors certainly make efforts to induce their friends and relations to purchase shares, and, therefore, they are entitled to a commission to the extent of such sales. In that case it should not be advertised in the prospectus that the friends and relations of the directors have applied for so many shares. It is not fair that the directors should earn commission on the sale of such shares, and at the same time, use it as an advertisement to convince the buying public of the soundness of the proposal. Either this fact should not be mentioned in the prospectus, or if it is mentioned, no commission should be paid to any one for the sale of such shares. In no circumstances should commission be paid to any one, least of all to the directors themselves, for shares applied for and taken by them in their own names. This amounts to selling of shares to the directors at a discount while others have to pay the full face value. This is an invidious distinction and an undesirable practice and the sooner legislations are made to stop it, the better.

In addition to the information given above, the following information is also to be included in the prospectus:—

**Auditors.**—A public joint-stock company has to get its account audited by a registered auditor and the annual balance-sheet and the profit and loss account must be certified by such an auditor before they are sent to the shareholders and to the Registrar. A company may appoint one or more auditors for the purpose, the number depending upon the nature and amount of work. Usually one auditor is appointed. As in the case of directors discussed before, an

auditor is appointed in the beginning by the promoters and subsequently he is appointed by election by the shareholders at the annual general meeting. The name and address of the auditor or auditors of the company must also be given in the prospectus. [Section 93(1) (m).]

#### **Rights, Privileges and Restrictions of Members.—**

When a company has more than one class of shares, it is necessary to mention the right of voting at the meetings of the company and the rights in respect of capital and dividends attached to each class of shares. Where the articles of the company impose any restrictions upon the members of the company in respect of the right to attend, speak or vote at meetings of the company or of the right to transfer shares, or upon the directors of the company in respect of their powers of management, the nature and extent of these restrictions should be mentioned. [Section 93(1) (o) (p).]

#### **Prospectus Issued by an Existing Company.—**

Where a prospectus is issued by an existing company for additional capital, the prospectus must contain the following reports<sup>2</sup> in addition to the information discussed above and as required by Section 93(1) of Indian Companies Act, 1913:—

(1) A report of the auditors of the company of profits made by the company for the three financial years preceding the issue of the prospectus; the rates of dividends, if any, paid to the different classes of shareholders for each of the said three years; the source from which such dividends have been paid; particulars where no dividend has been paid on any class of shares for any of those years; whether accounts have been made up to a date within three months before the

<sup>2</sup> Indian Companies (Amendment) Act, 1936, Section 93(1A).

date of the prospectus. In case the company has been carrying on business for less than three years the above statement should be given for two years or less, as the case may be.

(2) If a business is to be purchased out of the proceeds of the issue of the shares or debentures, a report by a qualified accountant named in the prospectus on the profits of the business for each of the three preceding financial years.

The requirements of this section as to the memorandum and the qualification, remuneration and interest of directors, the names, descriptions and addresses of directors, or proposed directors, and of managers or proposed managers, and the amount or estimated amount of preliminary expenses, shall not apply in the case of a prospectus issued more than one year after the date on which the company is entitled to commence business. [Section 93(1c) (4).]

**Statement in lieu of Prospectus.**—Section 93 makes it compulsory for every company to publish the above information in a prospectus. It is not compulsory for a company to publish a prospectus, and if it does not do so, the required information is to be given in a statement in lieu of prospectus which must be signed by every person who is named therein as a director or a proposed director of the company or by his agent authorised in writing, in the form and containing the particulars set out in the form marked in the Second Schedule. A company is not permitted to allot any of its shares or debentures before a statement in lieu of prospectus has been filed with the Registrar. (Section 98.) This section shall not apply to a private company or to a company which has allotted any shares or debentures before the commencement of this Act or, in so far as it relates to the allotment of shares to a company limited by guarantee and not having a share capital.

Sometimes a company, instead of selling its shares or debentures directly to the public, may allot them to issuing houses or persons with a view to their being offered for sale to the public. The document by which the offer for sale to the public is made by these persons or issuing houses may be termed a sale prospectus to differentiate it from a subscription prospectus issued by the company directly. The sale prospectus shall for all purposes be deemed to be a prospectus issued by the company and all enactments and rules of law as to contents of prospectus and to liability in respect of statements in and omissions from the prospectus shall apply to it as to a subscription prospectus without prejudice to the liability of persons offering in respect of mis-statements. This is a new section (98A) which has been added by 1936 (Amendment) Act.

The sale prospectus must, in addition to other particulars required by Section 93, state (i) the amount of commission, brokerage or discount charged by the issuing persons, and (ii) the place at which the contract with the issuing persons may be inspected.

### Section 3—Allotment of Shares & Meetings

**Application and Allotment of Shares.**—In the prospectus the following information is invariably given. “The subscription list is now open and shall close on such and such date or earlier, as may be decided by the directors.” The significance of the closing date is to inform the public that the shares will be allotted soon after that date and, in the event of the company receiving sufficient applications, the directors may decide not to wait for allotting till the last date and may do so earlier.

Applications can be made orally or by a letter, but usually companies require that they should be made on a specially printed form supplied by them. Forms are usually attached to the prospectus. Companies arrange with their bankers to receive applications and the investing public is requested to send the applications and the application money to the bank concerned. The bank receives the applications and enters them in the pass-book in order of their receipt and gives a receipt for the money received on the receipt form which also is generally attached to the application form. After the close of the last date of application, or earlier as required by the directors, the bank sends the applications and the pass-book to the company's office provided the minimum subscription has been applied for.

The last date for receiving applications can in no circumstances be beyond 180 days from the date of the issue of the prospectus, because a public company, according to Section 101(4), must make the first allotment of its share

capital within this time. Allotment may be described as the acceptance of any application for shares by the directors assigning to the applicant either the number of shares asked for by him or a lesser number. Such an allotment must be unconditional and must not introduce any new terms, which would make it not an acceptance but a fresh offer. The allotment must be made by a duly constituted board of directors. It is, however, not permitted to make any allotment of its shares unless the amount of minimum subscription as stated in the prospectus,<sup>1</sup> or where no such minimum is fixed, the whole amount<sup>2</sup> of share capital offered for subscription has been subscribed for and a sum of at least 5 per cent has been received in cash as application money<sup>3</sup> on each share subscribed. Failing the allotment of shares within 180 days, all the money received from applicants for shares must forthwith be returned to them without interest. If any such money is not so repaid within the next ten days, the directors of the company shall be jointly and severally liable to repay that money with interest at the rate of seven per cent per annum from the expiration of one hundred and ninetieth day. [Section 101 (4).] With the exception of the collection of 5 per cent cash on each share, none of the above conditions apply to any allotment of shares subsequent to the first allotment<sup>3</sup> of shares offered to the public for subscription.

In allotting shares, the directors of a company are not bound by priority of application. They can pick and choose. They can allot to those whom they please and refuse others. They may allot to some all the shares applied for, or only a part of them or nothing at all. After the allotment has

<sup>1</sup> Indian Companies Act, 1913, Section 101(1).

<sup>2</sup> Indian Companies Act, 1913, Section 101 (7) (b).

<sup>3</sup> Indian Companies Act, 1913, Section 101(6).



been made, information is sent to all the applicants. 'Letters of Allotment' are sent to those to whom shares have been allotted, and 'letters of regret' to others who have not been allotted shares. In the letter of allotment the secretary of the company, on behalf of the directors, informs the applicant of the number of shares which the directors have allotted to him and he is requested to pay to the company's banker the amount of the next instalment, *viz.*, the "allotment money." They are also requested to enclose the letter of allotment when sending the money to the banker. If a person has been allotted a part of the shares applied for, both 'letters of allotment' and 'letters of regret' are sent to him, and he is informed that the application money for the shares not allotted will be taken in payment for the allotment money for the shares allotted to him, and he is requested to send only the difference, if any. In case the application money is more than the allotment money which the applicant has to pay, the excess is refunded to the applicant.

It has been stated above that a company cannot begin its business immediately after incorporation till certain conditions as required by law are fulfilled. After the allotment of shares the secretary or one of the directors of the company has to inform and satisfy the Registrar that the remaining formalities have been complied with, and it is then that a certificate to commence business is issued by the Registrar, and that certificate shall be conclusive evidence that the company is so entitled. [Section 103(2).]

#### **Restriction on Commencement of Business\*.—A**

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\* *Note.*—For the convenience of readers and easy reference this portion is a repetition of what has already been described on page 96.

company should not commence business or exercise any borrowing power unless<sup>4</sup>:—

1. the proposed directors have allotted shares at least to the extent of the minimum subscription and have received cash of at least 5 per cent on such shares; and
2. every director has paid in cash the full amount of the application money and the allotment money on the shares subscribed by each; and
3. the secretary or one of the directors of the company has filed with the Registrar a duly verified declaration in the prescribed form that the aforesaid conditions have been complied with; and
4. in case the company has not issued a prospectus, a statement in lieu of prospectus has been filed with the Registrar.

#### GENERAL MEETINGS

After the allotment of shares and the receipt from the Registrar of the certificate to commence business, the directors of a company have to call a meeting of the shareholders. The meetings of shareholders are called general meetings to differentiate them from the meetings of the board of directors. In general meetings they deal with either ordinary matters such as, declaration of dividends, election of directors, etc. or special matters, *viz.*, alteration of memoran-

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<sup>4</sup> Indian Companies Act, 1913, Section 103(1).

dum of association, or of the articles. The former is called an ordinary general meeting, also called an annual general meeting; and the latter, an extraordinary general meeting. At ordinary general meetings, extraordinary matters can be discussed provided proper notice for it has been given to shareholders and in the agenda the items are marked as extraordinary. In extraordinary general meetings, only extraordinary matters are discussed. The first general meeting of a company is called the Statutory General Meeting and is compulsory for a public company, but it is not required of a private company. ~~Stat.~~

**Statutory General Meeting.**—Every company limited by shares and every company limited by guarantee and having a share capital must hold, after one month and within six months from the date at which the company is entitled to commence business, a general meeting of the members. It is called the Statutory Meeting and is intended to give the shareholders a complete stock of the company's situation as it has actually materialized. Before it the directors of the company are required to present a report called the Statutory Report showing the actual working and progress of the company. (Section 77.)

**The Statutory Report.**—The directors have to send at least 21 days before the day on which the meeting is held a report called the statutory report to every member of the company. [Section 77(2).] The report should be certified by not less than two directors of the company or by the chairman of the directors, if so authorised by the directors. It should give the following information:—

1. The total number of fully and partly paid-up shares allotted, otherwise than in cash, and the consideration for which they have been

- allotted, and in the case of partly paid-up shares the extent to which they are so paid-up.
2. The total amount of cash received by the company in respect of all the shares allotted.
  3. An abstract of the receipts of the company and of the payments made thereout up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company showing separately any commission or discount paid on the issue or sale of shares.
  4. The names, addresses and descriptions of the directors, auditors, managing agents and managers, if any, and the secretary of the company and the changes, if any, which have occurred since the date of the incorporation.
  5. If modification of any contract is desired, it should be submitted to the meeting for its approval, together with the particulars of the modification or the proposed modification.
  6. The extent to which underwriting contracts, if any, have been carried out.
  7. The arrears, if any, due on calls from directors, managing agents and managers.
  8. The particulars of any commission or brokerage paid or to be paid in connection with the issue or sale of shares to any director, manag-

ing agent or manager or a partner of the managing agent if the managing agent is a firm or, if the managing agent is a private company, a director thereof.

The statutory report so far as it relates to the shares allotted by the company, the cash received in respect of such shares, and the receipts and payments of the company, should be certified as correct by the auditors of the company. A certified copy of the statutory <sup>report</sup> should be sent to the Registrar for registration immediately after a copy has been sent to each of the members of the company.

The directors should prepare a list showing the names, descriptions and addresses of the members of the company, and the number of shares held by each. It should be placed on the table at the commencement of the meeting, and should remain open and accessible to any member of the company during the continuance of the meeting.

The members of the company present at the meeting shall be at liberty to discuss any matter relating to the formation of the company or arising out of the statutory report, whether previous notice has been given or not, but no resolution of which notice has not been given in accordance with the articles may be passed. The meeting may adjourn from time to time, and at any adjourned meeting any resolution of which notice has been given in accordance with the articles, either before or subsequent to the former meeting, may be passed, and the adjourned meeting shall have the same power as an original meeting.

If a petition is presented to the court for winding up the company on the ground of default in filing the statutory report or in holding the statutory meeting, the court may, instead of directing that the company be wound up, give

directions for the statutory report to be filed or a meeting to be held, or issue such other orders as may be just.

In the event of any default in complying with the provisions of Section 77 dealing with statutory meeting of a company, every director of the company, who is guilty of or who knowingly or wilfully authorises or permits the default, shall be liable to a fine not exceeding Rs. 500. This section does not apply to a private company, or a company limited by guarantee and not having a share capital, or an unlimited company. It may be noted here that this is one of the few sections in which the 'company' has not been penalised.

**Ordinary or Annual General Meeting.**—All associations and clubs are managed by a body variously known as the managing committee, the board of management, etc., elected by their members from amongst themselves. Usually at the end of every financial year a meeting of the general body, that is, of all the members of the association or the institution, is held where the secretary or the manager or the president, as the constitution may be, gives on behalf of the committee a review of the activities of the institution for the preceding year, its progress and its financial condition. In the same way, the board of directors of a company elected by its members from among themselves manage the business of the company. This board convenes every year a meeting of the shareholders after the closing of the financial year and at the meeting makes a survey of its stewardship of the company during the preceding year. The shareholders who are the members of the company are very much more interested in these annual meetings than the members of an association or club because one of the most important items of its business is the declaration of dividends by the com-

pany for its shareholders. These meetings are called 'ordinary general meetings' or 'annual general meetings' and the review or the survey read out by the chairman of the board of directors on behalf of the board of directors is called the 'Directors' Report'.

A general meeting of every company must be held within eighteen months from the date of its incorporation and thereafter once at least in every calendar year and not more than fifteen months after the holding of the last preceding general meeting. Failure to hold such a meeting will make the company and every director or manager of the company who is knowingly and wilfully a party to the default liable to a fine not exceeding Rs. 500. In case of default, the court may, on the application of any member of the company, call or direct the calling of a general meeting of the company. (Section 76.) It is important to bear in mind that it is compulsory for a private company also to hold its annual general meetings.

I should like to draw the attention of the readers to the difference in the penalty clause in case of default in holding an annual general meeting as compared to the statutory meeting of the company. Section 76(2) of the Indian Companies Act, 1913, makes three parties, *viz.*, the company, every director and the manager, liable for not holding an annual general meeting of the company, whereas by Section 77(10) only the directors are liable for not holding the statutory meeting of the company. The exclusion of the manager of a company from any penalty, in case the statutory meeting of the company is not held or all the formalities in this connection are not observed, is obvious. From the time of incorporation till the holding of the statutory meeting, the directors play all the parts in the organisation of the company.

The work of the manager, in its true sense, does not begin till the company begins its operation and the company does not or may not begin its operation till the statutory meeting is held, the reason being that the statutory meeting is held after a month or so from the date the certificate to commence business is obtained. The manager naturally may not have the time and opportunity to take the responsibility of calling the statutory meeting. It is, therefore, reasonable to exclude the manager from any penalty for not holding the statutory meeting. But this condition does not exist when the company has started its work because the business is in the hands of the manager long before the annual general meeting is held. It is then the duty of the manager to see that the annual meeting is held in time and if this is not done, it will be proper to penalise him for the default. In connection with the holding of meetings, the position of a company is slightly different from that of its manager or directors. The basis on which a company is exempted from any such penalty is that penalising a company is equivalent to penalising the shareholders who are really not a party to any default. The calling of meetings of a company, really speaking, is the function of the secretary or the manager of the company, or its directors, and not of the shareholders. The shareholders of a company should not be penalised for the default over which they have no control. It is on this principle that a company is not penalised when its statutory meeting is not held. If it is just not to penalise a company when the directors of the company fail to call its statutory meeting, why should it be otherwise, and the company be penalised, for not holding its annual general meeting? Justice requires that a company and, as such, its shareholders should be absolved from any liability for the mistake of its



directors and the sooner Section 76(2) is brought at par with Section 77(10), the better.

Some people are of opinion that the term 'manager' as stated in Section 76(2) does not include 'managing agents' and as such they are exempted from any penalty in failing to call an annual general meeting of a company. I do not think that this interpretation is correct. The law cannot differentiate between the two forms of management, the essential function of both being the same. The term 'manager' is used here in a wider sense, meaning an individual person, a firm or a company which may be made responsible for the management of a company, irrespective of the terms of the contract or agreement; and, therefore, it also includes managing agents.

I am inclined to go a step further and exempt managers or managing agents from any such penalty. Convening of meetings is really the function and responsibility of the secretary of the company, if any, and its directors and not of the managers and managing agents, and in case of default, they should be penalised and nobody else. But where law makes managers liable, there is no reason why the 'managing agents' should not equally be liable if the management of a company is under managing agents.

The business usually transacted at the annual general meeting consists of :—

1. The consideration of the balance-sheet and the profit and loss account, the directors' and auditors' reports.
2. The disposal of the available profits.
3. The election or re-election of directors.
4. The election or re-election of auditors and the fixing of their remuneration.

Special business may also be transacted if the notice convening the meeting adequately discloses the general nature of such business, provided that there is nothing in the company's articles confining special business to extraordinary general meetings only.

**The Annual Balance-Sheet.**—The directors of every company must lay before the company at its annual general meeting a balance-sheet and a profit and loss account or in the case of a company not trading for profit, an income and expenditure account for the period, in the case of the first account since the incorporation of the company and in any other case since the preceding account. The account should be made up to a date not earlier than the date of the meeting by more than nine months or in the case of a company carrying on business or having interests outside British India by more than twelve months. If there be any special reason, the Registrar may extend the period up to a maximum of three months.

The balance-sheet and the profit and loss account or income and expenditure account must be audited by the auditor of the company and the auditor's report should be attached thereto. The audited balance-sheet and profit and loss account or income and expenditure account together with a copy of the auditor's report must be sent by every company other than a private company to the registered address of every member of the company at least fourteen days before the date fixed for the meeting. A copy of these should also be deposited at the registered office of the company for the inspection of the members of the company during a period of at least fourteen days before that meeting. (Section 131.)

It is thus clear that a private company also has to get its accounts audited by the company's auditor who must

certify the balance-sheet and the profit and loss account of the company. A private company, however, is not required to send the audited balance-sheet and the profit and loss account to its members as is necessary in the case of a public company, but they must be placed on the table at the time of the meeting for the information of the members. [Section 131(3).] Again, a private company can appoint anyone as its auditor while the auditor of a public company must be a registered auditor. (Section 144.)

**Contents of the Balance-Sheet.**—According to Section 132 the balance-sheet shall contain a summary of the property and assets and of the capital and liabilities of the company giving such particulars as will disclose the general nature of these liabilities and assets and how the value of the fixed assets has been arrived at. The balance-sheet shall be in the form marked F in the third schedule to the Act or as near thereto as circumstances admit. The New Act (1936) has made considerable modifications in the contents of the balance-sheet, that is, in the information to be disclosed therein.

It is now necessary to show on the “Capital and Liability” side the following information:—

1. Unpaid calls :—
  - (i) from managing agents, and
  - (ii) from others.
2. Loans :—
  - (i) liabilities to subsidiary companies,
  - (ii) advances to directors, managers and managing agents.
3. Contingent liabilities :— the amount of guarantee given by the company on behalf of directors and officers of the company.

On the "Property and Assets" side are to be shown:—

1. "Discount" allowed on the issue of shares or so much as has not been written off at the date of the balance-sheet.

2. Under the heading of "advances":—(i) loans given to subsidiary companies, (ii) loans including temporary advances made at any time during the year to directors or managers of the company.

3. Under the heading of "cash":—(i) amount in hand, (ii) balances with agents and bankers in detail showing whether on deposit or current account.

**Profit and Loss Account.**—According to the new sub-clause (3) of Section 132, it is now necessary to give detailed information in the profit and loss account as given below:—

1. The particulars of the total amount paid as fees, percentages or otherwise to the managing agents (if any) and the directors respectively as remuneration for their services and, where a special resolution passed by the members of the company so requires, to the manager.

2. The total amount written off for depreciation.

3. If any director, by virtue of nomination of the company, is a director of another company, any remuneration or emolument received by him for his own use, whether as a director or otherwise, in connection with the management of the other company, shall also be shown in a note at the foot of the account or in a separate statement attached.

In addition to the above matters, Regulation 107 of Table A, which is compulsory for all companies, requires that the profit and loss account must show, arranged under the most convenient heads:—

4. The several sources of the gross income and the

amount of the gross expenditure distinguishing expenses of establishment, salaries and other like matters.

5. Every item of expenditure fairly chargeable against the year's income is to be shown, and, if the whole amount is not charged, the whole amount is to be stated, as also the reason why a portion is charged instead of the whole. The reason may be omitted only if so determined by the company at the general meeting. This exemption is provided in Section 17, Sub-Sec. (2).

The balance-sheet and the profit and loss account must be signed by the manager or the managing agent, as the case may be, and also by at least three directors in the case of banking companies and two for companies other than banking, and where a company has less than two directors by the sole director. (Section 133.) After the balance-sheet and profit and loss account have been laid before the company at the general meeting, three copies of the balance-sheet and the profit-and-loss account,<sup>5</sup> signed by the manager or secretary, of the company has to be filed with the Registrar along with the copy of the annual list of members and summary prepared in accordance with the requirements of Section 32. If the general meeting, before which a balance-sheet is laid, does not adopt the balance-sheet, a statement of that fact and of the reasons therefor shall be annexed to the balance-sheet and to the copy thereof required to be filed with the Registrar. A private company is not required to file a balance-sheet with the Registrar. (Section 134.)

**Directors' Report.**—The directors have to prepare a report called the Directors' Report with respect to the state of the company's affairs, the amount, if any, which they recommend should be paid by way of dividend and the

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<sup>5</sup> Section 134 as amended by Act II, 1938.

amount, if any, which they propose to carry to the Reserve Fund. This report should be attached to every balance-sheet and it should be signed by the chairman of the directors on behalf of the directors, if so authorised.

In the preparation of the report care should be taken to give information in a manner that it will give satisfaction to the shareholders. The shareholders are interested primarily in the profits earned by the company, in the dividends proposed to be paid and in its financial stability. With this end in view, the amount of the gross profit, its distribution towards the reserve fund, divided to the shareholders, etc., should be given in the beginning and in a form that the directors shall have no difficulty in finding them. These are to be followed by a review for the whole year giving reasons for the increased or decreased profits, as the case may be, earned by the company. Lower profits in any year need not be a sign of inefficiency of the directors, as it may be due to conditions over which they had no control. Similarly, they should not take credit from increased profit if it is due to unusually favourable conditions which can never last long and the profit is bound to be less again the next year or soon after. It will then be necessary to find out excuses for the fall in profits.

**The Annual Return.**—The annual return or the Annual List of Members and Summary as it is also called, is the statement which every company is required to file with the Registrar of Companies once at least every year. (Section 32.)

1. It is a list containing the names, addresses, and occupations of all the present members of the company, and also of the past members who have ceased to be so since the date of the last return.

2. The list should give the number of shares held by each of the existing members on the date of the return.

3. It should also show shares which have been transferred since the date of the last return by persons who are still members and persons who have ceased to be such, and the dates of registration of transfers.

4. A summary should also be given showing separately, shares issued for cash, shares issued as fully or partly paid up otherwise than in cash, and also the following particulars:—

- (a) the amount of the share capital of the company, and the number of shares into which it is divided;
- (b) the number of shares taken from the commencement of the company up to the date of the return;
- (c) the amount called up on each share;
- (d) the total amount of calls received;
- (e) the total amount of calls unpaid;
- (f) the total amount of sums (if any) paid by way of commission in respect of any shares or debentures, or allowed by way of discount in respect of any shares or debentures, since the date of the last return, or so much thereof as has not been written off on the date of the return;
- (g) the total number of shares forfeited;
- (h) the total number of shares or stock for which share-warrants are outstanding on the date of the return;
- (i) the total amount of share-warrants issued and surrendered respectively since the last return;

- (j) the number of shares or amount of stock comprised in each share-warrant;
- (k) the names and addresses of the directors of the company and also of the managers and managing agents (if any) on the date of the return, together with the changes in the personnel of all the said persons since the last return and the dates on which they took place;
- (l) the total amount of debt due from the company in respect of all mortgages and charges which are required to be registered with the Registrar under this Act.

The above list and summary shall be contained in a separate part of the register of members and shall be completed within twenty-one days after the day of the first or only ordinary general meeting in the year. The company shall forthwith file with the Registrar a copy thereof, signed by a director, manager or secretary of the company, together with a certificate signed by the director, manager or secretary that the list and summary state the facts as they stood on the aforesaid date.

Private companies must give a certificate (1) that they have not made any offer to the public for subscription of their shares or debentures; and (2) where the total membership exceeds fifty, that such excess consists wholly of persons who are or have been in the company's employment.

The return must also state the address of the registered office of the company. Public companies must also include three copies of the audited balance-sheet and the profit and



loss account of the last year as required by Section 134 of the amending Act II of 1938.

In case of default the company and every official shall be liable to a fine of Rs. 50 per day so long as the default continues.

**Extraordinary General Meeting.**—All meetings of the company other than the ordinary general meeting are termed extraordinary general meetings. Special business of which the general nature must be clearly and fairly disclosed in the notice convening the meeting will be transacted at these meetings. It is true that in the extraordinary general meetings only special business is to be transacted but there is nothing to prevent these matters being discussed and decided upon at ordinary general meetings, provided proper notice as required by law has been given. The directors may, whenever they think fit, call an extraordinary general meeting, and must call it immediately on the requisition of the holders of not less than one-tenth of the issued share capital of the company upon which all calls and other dues have been paid. The requisition must state the objects of the meeting, and must be signed by the requisitionists and deposited at the registered office of the company. If the directors do not call a meeting within twenty-one days from the date of the receipt of the requisition, the requisitionists or a majority of them in value, may themselves call the meeting, but any meeting so called must be held within three months from the date of the deposit of the requisition. Any reasonable expense incurred by the requisitionists for holding such a meeting must be paid by the company and the company shall realize the amount from the defaulting directors out of their fees or other remuneration. (Section 78.)

## RESOLUTIONS

A company has to deal with three classes of resolutions, *viz.*, (1) ordinary resolutions for ordinary matters, (2) extraordinary resolutions and (3) special resolutions for special matters. Whether a resolution is ordinary, extraordinary or special, depends upon the subject-matter. In the different sections of the Indian Companies Act, 1913 as amended in 1936, it is given whether a resolution for the subject-matter in that section should be ordinary, extraordinary or special. For the convenience of the readers these are given later.

For ordinary and extraordinary resolutions fourteen days' notice<sup>6</sup> is necessary and for special resolutions twenty-one days' notice.<sup>7</sup> These periods may be reduced, provided all those who are entitled to receive notice agree.

Ordinary resolutions are those used for the disposal of ordinary business at annual general meetings, for example, the payment of dividends, appointment or re-appointment of auditors, and election or re-election of directors. These resolutions can be passed by a simple or bare majority, either by a show of hands, or at a poll, should one be demanded. The articles usually provide that a chairman has a casting vote in the event of an equality of votes "for" and "against." Extraordinary and special resolutions are required to be passed by three-fourths of the majority, that is, by 75 per cent votes of members present in person or by proxy (where proxies are allowed) at a general meeting of which notice specifying the intention to propose the resolution as an extraordinary or a special resolution has been given.<sup>8</sup>

<sup>6</sup> Indian Companies (Amendment) Act, 1936, Section 79(1)(a).

<sup>7</sup> Indian Companies (Amendment) Act, 1936, Section 81(2).

<sup>8</sup> Regulation 50, Table A.

Formerly the difference between an “extraordinary” resolution and a “special” resolution was that the latter, on being passed in the manner of an extraordinary resolution, had to be confirmed as an ordinary resolution at a meeting held at an interval of not less than 14 days, nor more than a month, from the date of the first meeting. Now, a special resolution does not require this confirmation at a second meeting. It will have to be passed in the manner of an extraordinary resolution (*i.e.*, by 75 per cent of votes), but the meeting must be convened at not less than twenty-one days’ notice, unless the members entitled to attend and vote agree to a shorter notice.

A copy of every special and ordinary resolution shall, within fifteen days from the passing thereof, be printed or typewritten and duly certified under the signature of one of the officers of the company and filed with the Registrar who shall record the same. A copy of every special resolution for the time being in force shall be embodied in or annexed to every copy of the articles issued after the date of the resolution. (Section 82.)

**Invalid Resolutions.**—Resolutions passed at general meetings are subject to attack as being invalid in the following circumstances:—

1. When the resolution proposes to do something which is *ultra vires* the company or which is in conflict with statute law.
2. When the meeting itself is not a valid meeting, *e.g.*, convened by an improperly constituted board meeting.
3. When the provisions of the Companies Act or the company’s own articles regarding the

notices convening the meeting or the conduct of the business thereat are not observed.

4. Where the business is "special" and the nature of the business is not fully disclosed in the notice convening the meeting.
5. When the resolution is oppressive or is a fraud upon the minority.
6. When the resolution is not *bona fide* for the benefit of the company as a whole.
7. Where an amendment or proposed amendment has been improperly excluded by the chairman of the meeting.

**Votes and Voting Procedure.**—The articles of association of a company lay down rules for holding meetings and prescribe the procedure to be observed in connection with voting at general meetings, and the prescribed regulations must be strictly observed.

**Quorum.**—A quorum is the minimum number of qualified persons who must be present at the time when the meeting proceeds to business and continue to be present till the meeting is over. No business shall be transacted at a meeting unless there is quorum throughout the meeting. The articles of association of companies and the standing orders or rules of bodies, fix the number necessary. Regulation 51 of Table A and Section 79(2) (b) provide that two members in the case of a private company and five members in the case of any other company personally present shall form a quorum at general meetings. The quorum for directors' meetings is usually fixed by the articles; where no provision is made a majority of the board must be present. In the absence of special provisions in the articles, proxies are not

allowed to be included in the quorum. This will at least have the effect of discouraging the provision, sometimes made in the articles, of a quorum including proxies, by which it is possible to have a meeting consisting of one member only with the help of proxies.

**Votes.**—Regulation 56 of Table A has been made obligatory for all companies and lays down the procedure for deciding questions by votes. The vote is taken either by a show of hands or by a poll. Usually, the vote is taken by a show of hands, on the principle of “one man one vote”. Everyone present who is entitled to vote has one vote only irrespective of his holdings. But when the voting is by a poll, absent members may vote through their proxies and members present as well as absent members, through their proxies, may exercise the number of votes to which any one of them may be entitled. When a question is decided on a show of hands the articles of most companies provide that the chairman’s declaration that a resolution has been carried shall be deemed conclusive evidence of the fact.

Regulation 56 and also Section 79(1) (c) of the Indian Companies (Amendment) Act, 1936, govern the procedure for voting by poll. In the case of a public company, five members present in person or by proxy, or the chairman of the meeting, or any member or members holding not less than one-tenth of the issued capital which carries voting rights, may demand a poll; and, in the case of a private company, if not more than seven members are personally present, one member, and if more than seven members are personally present, two members, may demand a poll. A demand for poll must be granted by the chairman if it is made by a sufficient number of persons who are qualified to vote. The

chairman is usually empowered by the articles to decide the manner in which the poll is to be taken, and he may, if necessary, adjourn the meeting for this purpose.

On a poll votes may be given either personally or by proxy, and every member shall have one vote in respect of each share or each hundred rupees of stock held by him.<sup>9</sup> Sometimes a company may provide different voting powers for different classes of shares and in the same class of shares votes at decreasing rates for additional shares beyond a certain minimum. For instance, one may have one vote for every share up to five votes. Thereafter, one vote for every five shares up to another five votes, and again one vote for every ten additional shares. But usually it is one vote for every share or each hundred rupees of stock without any restriction. It is also provided in the articles that no member is entitled to vote at any general meeting unless all calls or other sums presently payable by him in respect of shares in the company have been paid. (Regulation 63, Table A.)

**Proxy.**—A proxy is a person who is authorised to attend and vote at a shareholders' meeting on behalf of another person, but the term is more generally used to denote the document by which the person is authorised to act. At common law, there is no right to vote by proxy; but the articles of association of most companies contain regulations providing for and governing the use and form of proxy.

Proxies must be in writing, executed by the shareholder or his duly authorised attorney. When executed by a corporation, the proxy must be (1) under the common seal, or

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<sup>9</sup> Regulation 60 of Table A.

(2) under hand by an officer of the corporation or attorney appointed under seal. Articles usually provide that no person shall act as a proxy unless he is a member of the company.<sup>10</sup> The proxy form must be lodged at the company's office not less than seventy-two hours before the time fixed for the meeting. If the instrument has been signed by a person other than a member, a power of attorney or other authority under which it is signed or a copy thereof certified by a notary has also to be so deposited. In default, the instrument of proxy will not be valid. The above regulation (Regulation 66) is compulsory; hence it applies to all companies.

Most articles empower the chairman to give a casting vote in the event of an equality of votes, either on a show of hands or on a poll; but in the absence of provisions to that effect, the chairman cannot do so, as at common law he does not possess this right.

**The Nature of Business which a Company may Transact at a General Meeting:—**

**I. By Ordinary Resolution (14 days' notice and simple majority).**

1. The alteration of its share capital. (Sec. 50.)
2. The registration of an unlimited company as a limited company. (Secs. 67-68.)
3. The business of the annual general meeting:—
  - (a) adoption of the balance-sheet and accounts. (Sec. 131.)
  - (b) election of directors. (Secs. 83B and 86G.)

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<sup>10</sup> Regulation 65 of Table A and Section 79 (2)(f)(g) Indian Companies (Amendment) Act, 1936.

- (c) appointment of auditors and fixing their remuneration. (Sec. 144.)
- (d) declaration of dividends. Regulation 95, Table A.)
- (e) appropriation from profits to reserves.
- 4. Adoption of the statutory report. (Sec. 77.)
- 5. To permit a director or a firm of which such director is a partner or a private company of which such director is a director to hold an office of profit. (Sec. 86E.)
- 6. Selling or disposing of the undertaking of the company or remission of any debt due by a director. (Sec. 86H.)
- 7. Appointment or removal of a managing agent, alteration of his contract and the transfer of office by a managing agent. (Sec. 87A and B.)
- 8. Issuing of shares at a discount. (Sec. 105A.)
- 9. To appoint representatives to inspect the books of a subsidiary company. [Sec. 132A (5).]
- 10. Winding-up a company under Section 203(1).
- 11. In a voluntary winding-up appointment of liquidators and fixing their remuneration, consideration of accounts submitted by liquidators and dissolution of the company. (Secs. 208-209.)

**II. By Extraordinary Resolution** (14 days' notice and 75 per cent majority).

- 1. Removing a director. (Sec. 86G.)



2. Winding-up a company when it cannot by reason of its liabilities continue its business. [Sec. 203(3).]
3. Disposing of the documents of the company in a voluntary winding-up. (Sec. 242.)

**By Special Resolution** (21 days' notice and 75 per cent majority).

1. Alteration of the name of the company. (Sec. 11.)
2. Alteration of the objects in the memorandum and change in the situation of the registered office from one province to another. (Sec. 12.)
3. Alteration of the articles of association. (Sec. 20.)
4. Reorganisation of share capital. (Sec. 54.)
5. Reduction of share capital. (Sec. 55.)
6. Creation of the reserve liability of a limited company. (Sec. 69.)
7. Alteration of the memorandum to make the liability of any of its director or directors unlimited. (Sec. 71.)
8. To approve the assignment of office by directors. (Sec. 86B.)
9. To sanction additional remuneration to the managing agent. [Sec. 87C (2).]
10. Payment of interest out of capital during construction. (Sec. 107.)
11. Appointment of inspectors to investigate its affairs. (Sec. 142.)

12. Winding-up a company without assigning any reason. [Sec. 203(2).]
13. Empowering the liquidator by general or special authority to accept shares, etc., as consideration for sale of property of company. (Secs. 208C and 209F.)

## Section 4—Shares and Debentures

**Shares.**—It has already been said that the capital of a company is divided into units called shares contributed by its members, the ownership of which determines the rights and obligations of the holder to the company and its creditors. Shares can be transferred only in multiples of the unit in which the capital is divided. After the allotment of shares and within three months of it, every company must issue a share certificate and give it to each shareholder under the common seal of the company, setting forth particulars of his holding, which particulars are recorded in the Shareholders' Register kept by the company. (Section 108.)

The shares of a company may be of one class only, all the shareholders having the same rights and privileges. They may be of two or more classes with different rights and privileges. Broadly speaking, shares may be divided into:—(i) preference, (ii) ordinary and (iii) deferred.

**Preference Shares.**—Preference shares have preference over other class or classes of shares. The preference may be with regard to the distribution of profits, that is, dividends only, or in the distribution of only the capital of the company, when the company is wound up, or both to dividends and capital as may be agreed upon by the memorandum and articles of association. (Preference shares are entitled to receive dividends up to a pre-determined fixed percentage before any other class of shares is entitled to any dividend. )

It must be clearly understood that dividends are to be paid out of profits only and not from the capital,<sup>1</sup> irrespective of the class of shares, and even when there is a profit, the payment of dividends to the shareholders depends upon the decision of the directors of the company.<sup>2</sup> They may decide to distribute only a part of the profit or nothing at all to the shareholders, preferring to build up a reserve fund, or to use it in the expansion of the business instead of getting additional capital by issuing new shares. (The only condition is that the directors are not to give any dividends to any class of shareholders before paying the preference shareholders up to the fixed amount to which they are entitled.) Suppose a company has issued 5 per cent preference shares, carrying preference both in respect of dividends and capital. Then, in any particular year, if sufficient net profits were realised, 5 per cent must be paid on these shares before any other class of shares can participate at all. In the event of a winding-up, if it is assumed that a return of capital is possible, the capital represented by these shares must be returned to the preference shareholders before the other classes of shareholders receive a return of their capital.

**Cumulative Preference Shares.**—(Should there be insufficient profits to pay the fixed percentage or any portion of it in any year, the arrears must be carried forward and paid out of future profits before any other class of shares is entitled to any dividend. The unpaid dividends do not lapse; they accumulate. These are called cumulative preference shares.) (There is another class of preference shares

<sup>1</sup> Regulation 97, Table A

<sup>2</sup> Regulation 95, Table A.

} Both the Regulations are compulsory for every company.

in which dividend not paid in any year is non-cumulative, that is, not recoverable out of future profits. This is simple preference, as opposed to cumulative preference. For example, in the case of 5 per cent cumulative preference, if in any year the preference shares have been paid 3 per cent only, the balance of the unpaid amount, *viz.* 2 per cent will be carried forward and next year these shares must be paid 7 per cent (2 per cent of the last year's arrears and 5 per cent of the current year) before anything can be paid to any class of shares. This is not so with the other class of preference because with this class of preference the unpaid dividend of any year lapses and is not carried forward, and in the next year the shareholders become entitled to the fixed percentage.

It is an accepted principle that every company, to make its financial position strong, should gradually build up a reserve fund for lean years and to meet future losses. It is, therefore, necessary to set aside every year for the reserve fund a certain portion of profits earned. If a company makes insufficient profits in any year, it is better to pay less to the shareholders and to build a reserve fund to strengthen the financial position of the company. It is not possible to say with mathematical accuracy what the amount of a reserve fund should be, nor can there be any hard-and-fast rule for it. The amount of reserve fund necessary for a company depends upon the nature of the industry or business and the amount of capital already raised.

The difference between the two classes of preference shares has a far-reaching effect on the shares themselves, and also on the company when it issues both preference and ordinary shares and when the preference is simple or ordinary. This is due to the fact that the directors of a

company decide the distribution of the company's profits and in this they may be influenced by self-interest, depending upon whether they have more interest in the preference shares or in the ordinary shares. The policy and interest of the directors do not materially affect the cumulative preference shares because dividends not paid in any year do not lapse and the whole of the accumulated arrears is to be paid from future profits. But this is not so with the ordinary preference share because any profits not paid in any year lapse. If the directors are more interested in the ordinary shares, self-interest may urge them to stress the importance for a large reserve fund and at a faster rate than may be necessary for the financial stability of the company. They may also utilize the profit in the expansion of the business: all this may be done at the cost of the preference shareholders who may be deprived of their due share of profits. On the other hand, if the directors have more interest in the preference shares the same self-interest may now turn the scale in favour of the preference shares and more dividends may be paid to this class of shares than circumstances may warrant, and this may be done at the cost of the financial stability of the company. To avoid such a situation it would be better if the law made it compulsory that all preference shares were cumulative. It is true that the most common type of preference shares is the cumulative preference share and in the absence of anything contained in the articles to the contrary, preference shares are always deemed to be cumulative with regard to the dividend.

The rights attached to preference shares are sometimes set out in the memorandum, but if this is done, they cannot be altered without the sanction of the court, unless a power of alteration is reserved in the memorandum. The usual

practice is, accordingly, either to set out the rights in the articles, when they can be altered by a special resolution, or else to set them out in the memorandum, reserving a power of alteration. If the preference rights are set out in the memorandum without any power of alteration, they can be altered as part of a scheme of arrangement, involving a resolution passed by a majority in number representing three-fourths in value of the preference shareholders present at the meeting, and the sanction of the court. Preference shares with rights set out in the memorandum can also be consolidated with other shares as part of a re-organisation by special resolution, sanctioned by a resolution of the preference shareholders, passed by an absolute majority in number and three-fourths in amount of the preference shareholders, whether present or not at the meeting, confirmed by the order of the court.<sup>3</sup> But a limited company cannot reduce its capital, either by direct or by indirect means, without the sanction of the court. The inviolability of the capital is a condition of incorporation.

**Participating Preference Shares.**—There is still another form of preference which enjoys all the privileges of a preference share and entitles the holder to a fixed rate of dividend in priority over other classes of shares and, in addition, to participating in a further dividend (if profits permit), with other classes of shares as may be agreed upon by the articles of association. This is called a participating preference share.) Participating preference shares have the first claim to a fixed dividend, say, 4 per cent, the next claim is that of the ordinary share, say, up to 8 per cent, and the

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<sup>3</sup> Encyclopedia Britannica, 14th Edition, Vol. 6, page 143.

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balance of profits, if any, is distributed between the two classes of shares on an agreed basis.

✓**Ordinary Shares.**—(There are shares having no special rights, and simply participating in the profits available after all prior classes have been satisfied.) If there are deferred interests, ordinary shares usually take a fixed percentage of profits before the deferred shares participate. If a company has only one class of shares called ordinary shares, the net profits, subject to any appropriation for building up a reserve fund, etc., is equally distributed among the shareholders.

✓**Deferred Shares.**—(Sometimes ordinary shares are divided into two classes, *viz.*, preferred ordinary and deferred ordinary. The relationship between these two is similar to the one found between non-cumulative preference shares and ordinary shares.) Where both deferred and ordinary shares are issued the deferred shares are not entitled to receive any dividend till the ordinary shares have been paid a certain fixed rate, and thereafter the deferred shares participate in the balance, subject to a further deferred interest, *viz.*, founders' share, if there be any. (Deferred shares are often issued by companies when the nature of the business is such that there is a very great prospect of earning a large profit. This is true of mining companies.) They can easily issue all the three main classes of shares—preference, ordinary and deferred. In case the mine proves a success, the profit of the company is bound to soar very high, at the same time the market price of its shares will appreciate considerably. In such enterprises preference shares have not much of an investment value. If the mine proves to be a failure and the company goes into liquidation, the preference shareholders shall not have any material advantage over the ordinary and



deferred shareholders even if the preference share carries preference as to the return of capital. The reason is that the whole of the capital is irretrievably lost in costly machinery required in the working of mines. On the contrary, if the business succeeds, the preference shareholders shall have to be satisfied with a nominal but a fixed dividend between six to eight per cent, while the ordinary, but more so, the deferred shareholders, shall collect the booty in the form of large dividends. Further, the market price of these shares will then rise very high and the holders shall reap a harvest by selling them at high prices.

✓**Founders' or Management Shares.**—These are very limited in number, and are usually issued to promoters, or founders, or underwriters of shares.) In the early days of company floatations the promoters charged a remuneration for their services in conceiving the idea, in organising the company and in helping the investors to find a source of income for their surplus money. Later, when many such companies failed, dissatisfaction spread among the investors and resentment was expressed by them against the promoters and the payment of cash remuneration to them. It was said that the remuneration to the promoters was meant for promoting profitable companies and the test of their efficiency was in profits earned by the company. If a company failed, it was a clear proof of the inefficiency and unfitness of the promoter and he deserved no remuneration. The failure of a company meant a loss to the investors and there was no justification in putting them to an additional loss by paying the promoter in advance and before he proved that he deserved it. As a matter of fact, the promoters did not stand to lose anything, they got their remuneration all right, irrespective of the success or failure of the company. In

the event of failure, it was the investor who suffered the real loss. It was due to this that the payment was changed from cash to kind, that is, in shares of the company and the promoters were to receive remuneration in the form of dividends when the company earned profits. Gradually they were ousted from this position also on account of the continued failure of new companies. A vast majority of investors did not think it proper that the promoter should be at par and on the same level with the investors in receiving dividends. They said that the investors pay cash for purchasing shares of a company and also take the risk of losing even the principal by purchasing the shares of a company organised by the promoters. It is, therefore, reasonable to expect that the investors should be paid first a fixed percentage of dividend to compensate the risk taken by them and the rate of interest obtainable, and any profit earned by the company over and above this, a fixed percentage may be paid as remuneration to the promoters. The remuneration should, therefore, be paid in the form of shares which should be entitled to receive dividends after the investors, that is, after the holders of ordinary shares have been paid up to a fixed percentage. (These are just like deferred shares, the difference being that these are not sold to the public and are issued to the promoters or founders in limited quantities.) Hence these are called founders' or promoters' or management shares. Further a company may have ordinary, deferred and founders' shares. (The ordinary shares have the first claim up to a fixed percentage, the next claim is that of the deferred shares again up to a fixed percentage, and the balance, if any, is to be taken by the founders' shares.)

**Redeemable Preference Shares.**—It is permissible co-operative societies to refund their shares, but the

shares of a company incorporated under the Indian Companies Act are not refundable except (i) in case of winding-up and (ii) in case of reduction of capital effected in the manner laid down in Sections 54A—66. By Section 105B of the Amendment Act, 1936, it is now possible for a company limited by shares, if so authorised by its articles, to issue preference shares which are redeemable, or at the option of the company, are liable to be redeemed provided the following conditions are fulfilled:—

1. Such shares are allowed to be redeemed (i) out of profits available for dividend, (ii) out of the proceeds of a fresh issue, and (iii) out of the sale-proceeds of property.
2. No such shares are to be redeemed unless they are fully paid.
3. If they are redeemed out of profits or out of the sale-proceeds of the property, the company shall have to transfer from profits available for dividend, a sum equal to the amount required to redeem the shares, to a reserve fund to be called “the capital redemption reserve fund”. The reduction of this reserve fund shall be equivalent to and treated as a reduction of capital, consequently, the procedure as given in Sections 55—66 must be followed.
4. If the shares are redeemed out of the proceeds of a fresh issue, the premium, if any, payable on redemption must have been provided out of the profits of the company before the shares are redeemed.

In addition to the above conditions, it is further laid down that every balance-sheet of a company, which has issued redeemable preference shares, must give particulars of the issued capital in respect of redeemable preference shares, date of redemption, and, in the absence of a fixed date for redemption, period of notice to be given before redemption. Failure to comply with this provision of the balance-sheet shall render the company and every officer who is in default to a fine not exceeding Rs. 1,000.

The redemption of these preference shares may be effected on such terms and in such a manner as may be provided by the articles of the company subject to the provisions of Section 105B. If shares are issued in lieu of redeemable preference shares, it will not be an increase of capital on which additional fees have to be paid to the Registrar. If new shares are issued for the purpose of redeeming preference shares, an equivalent amount from the capital redemption reserve fund may be applied in issuing fully paid bonus shares.

**Issue of Shares at a Discount.**—Both in England and in India companies were not permitted to issue shares at a discount. On the recommendation of the Green Committee Report of 1925-26 the English Companies Act of 1929 introduced an innovation permitting companies to issue shares at a discount. India soon followed and got the change incorporated in Section 105A of the Indian Companies (Amendment) Act, 1936. The need for the change was long felt by the commercial communities both in England and in India. They were of opinion that at times companies, when in need of more capital to expand their business, found it difficult to sell shares at their face value and the only way in which they could do it was by selling them at

a lower price. But the law did not permit it. So people often had to resort to indirect methods in the garb of commission to those who agreed to subscribe the shares. The payment of commission to subscribers was allowed by Section 105 of the Indian Companies Act.

It is now lawful for a company to issue at a discount shares of a class already issued; provided the following conditions are fulfilled:—

1. The issue of the shares at a discount must be authorised by a resolution passed at a general meeting of the company and must be sanctioned by the court.
2. The resolution must specify the maximum rate of discount, not exceeding ten per cent in any case, at which shares are to be issued. (The English Act places no limit).
3. Not less than one year must have elapsed at the date of issue since the date on which the company was entitled to commence business.
4. The shares to be issued at a discount must be issued within six months after the date on which the issue is sanctioned by the court or within such extended time as the court may allow.

A further condition imposed is that every prospectus relating to the issue of shares and every balance-sheet issued by the company subsequent to the issue of the shares must contain particulars of the discount allowed on the issue of the shares or of so much of that discount as has not been written off at the date of the issue of the document in question.

**Further Issue of Capital.**—When a company is successful, its shares are more in demand by the investors and often they are sold at a premium. When such a company issues new shares to obtain necessary capital to expand its business, the existing shareholders naturally like to get the first preference to purchase them as against outsiders. To meet this legitimate demand of the shareholders, and also to prevent partiality and discrimination among the shareholders by the directors of the company, the Companies Act has provided by Section 105C that all classes of shares and shareholders should be treated alike.

Where the directors decide to increase the capital of the company by the issue of further shares, such shares shall be offered to the members in proportion to the existing shares held by each member (irrespective of class) and such offers shall be made by notice, specifying the number of shares to which the member is entitled, and limiting the time within which the offer, if not accepted, will be deemed to be declined; and after the expiration of such time, or on receipt of an intimation from the member to whom such notice is given that he declines to accept the shares offered, the directors may dispose of the same in such manner as they think most beneficial to the company. It must be understood that the issue of further shares includes issue of unissued shares included in the existing nominal capital, and does not, therefore, necessarily mean "increase of capital."

**Share-Warrants.**—Share-warrants to bearer may be issued by a public company when its articles of association, as originally framed or as altered by special resolution, authorise such issue and its shares are fully paid. A private company is not allowed to issue share-warrants. It is issued by a company under its seal and signed by the directors and

secretary in the same manner as a share certificate and is a document of title to the shares named therein. It is a negotiable instrument, and as it possesses all the privileges and characteristics of negotiability, a *bona fide* holder for value obtains a perfect title.

The share-warrant has a series of dividend coupons attached to it, and when a dividend has been declared by the company, the holder of the warrant must detach the relative coupon and present it at the prescribed office (usually the company's bankers) for payment.

The bearer of a share-warrant may, if the articles of the company so provide, be deemed to be a member of the company either to the full extent or for any purposes defined in the articles, except that he shall not be qualified, in respect of the shares or stock specified in the warrant, for being a director or manager of the company, in case where such a qualification is required by the articles. (Section 46.) The holder's name is not entered in the share register of the company, but he may at any time surrender his warrant for registered share certificates. The rules about share-warrants are governed by Sections 43—48.

On the issue of share-warrants, the company shall strike out from its register of members the name of the member then entered therein as holding the shares or stock specified in the warrant as if he has ceased to be a member, and shall enter in the register the following particulars:—

- (i) the fact of the issue of the warrant;
- (ii) a statement of the shares or stock included in the warrant with their respective numbers; and
- (iii) the date of the issue of the warrant.

If the company makes default in complying with the above, the company and every officer who knowingly and

wilfully permits the default shall be liable to a fine not exceeding Rs. 50 per day. (Section 47.)

Until the warrant is surrendered, the above particulars shall be deemed to be the particulars required by the Act to be entered in the register of members. When the warrant is surrendered, the date of the surrender shall be entered as if it were the date at which a person ceased to be a member. (Section 48.)

**Stock.**—Shares of a company of any one class are issued in one denomination only, but shares of different classes of the same company may be issued in different denominations. For example, preference shares may be of the nominal value of Rs. 100 each, and ordinary shares of Rs. 10 each. After shares are issued and are fully paid-up, they may be converted into stock, each holder of shares receiving an equivalent amount of stock, provided the articles of the company permit it. Stock cannot be directly issued. Shares must be issued first. Stock can again be reconverted into shares. The chief difference between shares and stocks is that the former can be transferred in multiples of its unit and the latter for any odd sums, such as, Rs. 151, Rs. 293, etc. At the Stock Exchange the price of shares is quoted for each unit of shares and stocks are quoted for Rs. 100.

**Calls.**—The share capital of a company is usually paid in instalments. The first and second instalments are called “application money”, and “allotment money” respectively, and the third and the subsequent ones are called “calls”. The term ‘call’ is used in two senses:—(1) the amount, and (2) the notice to the shareholder to pay the amount. It denotes both a demand for money and also the sum demanded. The articles prescribe how and by whom the calls are to be made. They are generally made by the directors and must



always be by a resolution, and as the call-making power is a trust, it must be exercised strictly as provided by the articles and for the general benefit of the company and not *mala fide* for private ends. A *mala fide* call is an abuse of power and the court may grant an injunction restraining it. If a call is not validly made, a shareholder is not bound to pay it. If the directors forfeit shares for non-payment of such calls, the shareholder can restrain them from doing so by injunction, or he can defend an action brought against him by the directors to recover such a call.

The directors have power, if authorised by the articles of the company, to receive from the members money in advance of calls, and pay them interest on such advance payments. If the company does not make profits, such interest may be paid out of capital. Section 49 permits a company, if authorised by its articles, to pay dividend in proportion to the amount paid up on such shares, when a larger amount has been paid on some shares than on others. On a transfer of shares the transferee is bound to pay all future calls and must indemnify the transferor against the same.

There is a difference between calls made by a company when it is a going concern and when it is in liquidation. In the former case, a call is made by the director and it is a liability by contract which has to be enforced by suit; whereas in the latter, the call is made by the liquidator and is a statutory liability which can be enforced by execution proceedings. Further, in the case of a going concern, a shareholder has a right to set off any debt due to him from the company against the call, but this is not allowed when the company is in liquidation. The reason is obvious, because this will amount to paying him in full in respect of such

debt, whereas the other creditors will get paid ratably. A person who is a creditor and also a contributory cannot be allowed to do what might amount to paying his own claim in full out of a fund which ought to be distributed ratably.

**Lien.**—A company has at law no lien on the shares of any member for his debts and liabilities to the company, but the articles generally provide that a company shall have a first and permanent lien on its shares held by its members for all their debts and liabilities to the company.

**Watered Capital and Overcapitalisation.**—When a company purchases an outgoing concern and pays for it more than its real value either in cash or in the shares of the company, or pays for its goodwill more than what ordinary prudence would approve, in either case the buying company will have less assets than paid for. The capital is then said to be “Watered” because a part of the asset of the company has no real value or has a fictitious value only. To the extent of water in the capital, profits of the shareholders of the company will be reduced. If a company has paid Rs. 2,000 for a property worth Rs. 1,000 only, and at the end of the financial year the income is Rs. 100, the business has really earned a profit of 10 per cent, but to the proprietors it comes to 5 per cent only. Watered capital or watered stock, as it is sometimes called, and “overcapitalisation” are not synonymous terms. When a company issues more capital than it can profitably utilize or expands in unprofitable channels, less profits result, and consequently the market value of the shares is below par. In the case of overcapitalisation, all the assets of the company are at their full value, there are no fictitious assets, and yet the market value of its shares is below par because the company is unable to develop sufficient earning power. There is overcapitalisa-

tion, only when the company is not earning sufficient to make its securities sell at par value. On the other hand, the capital of a company may be watered and yet it may earn sufficient profits to sell its shares above par. It will not be called overcapitalisation then.

**Forfeiture of Shares.**—The articles of a company generally provide that the directors shall have power to forfeit shares only on the ground of non-payment of calls. This is a power not inherent in the company apart from the articles. But before a share can be forfeited the directors must give a notice to the defaulting member to pay the amount within the specified time, which must not be less than 14 days from the date of the notice, and the notice must state that in the event of non-payment at or before the appointed time the share in respect of which the call was made will be liable to be forfeited. If the payment is not made within the required time a resolution of the directors forfeiting the shares can be passed after the expiry of the time and before the payment is made.

The forfeited share can be cancelled or reissued. The forfeited share ceases to exist as an issued share and becomes dead, *i.e.*, not issued to or held by any person and will not earn any dividend. As a matter of fact the capital will be reduced by the amount of this share. So long as it is not sold or reissued it remains with the company, but the company thereby does not become its owner, just as it does not become owner of the original shares not taken up by the public, though the company can reissue them.

A person whose shares have been forfeited ceases to be a member in respect of the forfeited shares, but he still remains liable to the company for the unpaid amount of the shares and his liability ceases only when the company

receives the payment in full of the nominal amount of shares.

Whenever a share is forfeited it amounts to a reduction in the capital of the company. According to Section 55 the reduction of the capital requires a special resolution and the sanction of the court, but the reduction of capital upon forfeiture is exempted from this rule.

The forfeited share can be sold or reissued on such terms and in such a manner as the directors think fit. They can issue it at a discount which is apart from and independent of the provision of the Act authorising the issue of shares at a discount. The person to whom the share is sold shall be registered as the holder of the share and his title to the share shall not be affected by any irregularity or invalidity in the proceedings in reference to the forfeiture, sale or disposal of the share. Before the share is sold or reissued, the directors have power to cancel the forfeiture and restore the forfeited share to its original holder on such terms as they think fit.

**Surrender of Shares.**—The Indian Companies Act and Table A recognise forfeiture of shares, but they make no mention about the surrender of shares by a shareholder to the company. (A surrender of shares, however, is recognised by law on one condition only, *viz.*, that *the circumstances must be such as would justify a forfeiture*) In all other cases, a surrender of shares by a holder to the company is invalid, because such a surrender amounts to a reduction of the capital of the company which under the Companies Act is prohibited and can be effected according to Section 55, if so authorised by articles of the company, only by a special resolution of the company subject to confirmation of the court. It is, therefore, possible to provide in the

articles of a company that shares can be surrendered and the surrender can be accepted by the directors under certain conditions.

**The Duties of the Subscribers to the Memorandum.**—They are:—(i) to pay for the shares they have subscribed, (ii) to sign the articles of association, (iii) to appoint the first directors, and (iv) to act as such directors till the first directors are appointed. Their further duties are to file the necessary documents with the Registrar and get the company registered.

**The Register of Members.**—Section 31 of the Indian Companies Act, 1913, provides that the following information shall be entered in the Register of Members:—

1. Names, addresses, and occupations of the members.
2. When the company has a share capital, particulars of shares held with their distinctive numbers, and the amount paid or agreed to be considered as paid on each share.
3. Date of entry of each person as a member.
4. Date at which any person ceases to be a member.

It is further provided by Section 33, that no notice of any trust, express, implied or constructive, shall be entered on the register, or be receivable by the Registrar.

The new Amending Act of 1936 makes it compulsory, by Section 31A, for every company having more than fifty members to keep a separate index of members, unless its register of members is so arranged as to constitute such index.

**Variation of Shareholders' Rights.**—The Amending Act of 1936 has provided by Section 66A that where a

company limited by shares has different classes of shares and the memorandum of the company and its articles permit alteration of rights annexed to any class of shares with the consent of a specified portion of holders of that class, or with the sanction of a resolution passed at a separate meeting of the members of that class, and the said rights are varied at any time accordingly, then the holders of not less than 10 per cent of the issued share capital of the class, who did not consent or vote in favour of the resolution for the variation, may apply to the court to have the variation cancelled, and where any such application is made, the variation shall not take effect unless and until it is confirmed by the court. The application must, however, be made within fourteen days of the consent or the passing of the resolution, by one or more members of the class objecting. The court after hearing the application and any other persons who apply to the court to be heard may, if it is satisfied that the variation would unfairly prejudice the shareholders of the class represented by the applicant, disallow the variation, and if the court is not so satisfied it will confirm it. The decision of the court on any such application will be final. A copy of the court's order is to be filed with the Registrar within fifteen days of the service of the order. Default in filing is penalised.

**Liability of Promoter.**—(1) A promoter, who makes a secret profit, is accountable to the company for the same. (2) If he sells his own property to the company, he must make a complete disclosure of his interest therein, otherwise the transaction will be set aside or he shall be made to refund the profit he has made. (3) If he is guilty of an untrue statement in a prospectus, (a) the allotment of shares will be liable to be set aside on the ground of misrepresentation;

(b) he may be liable to damages for deceit or for misrepresentation under the special remedy given by Section 100.

(4) A promoter is also liable to be proceeded against under Section 235 on a misfeasance summons. He is liable to be prosecuted under Section 282, for issuing a false prospectus.

(5) If he issues a prospectus which does not comply with the provisions of Sec. 93, he is also liable to the penalty laid down by Sec. 97.

### DEBENTURES

The capital of a company is obtained by issuing shares, that is, by selling proprietary rights of the company, and when necessary, by borrowing from the public, that is, by issuing "debentures." The term 'debenture' ordinarily means a document which either creates a debt or acknowledges it. A company is debarred from borrowing unless it is expressly or impliedly authorised to do so by its memorandum of association. In the case of a trading company, borrowing is impliedly authorised as a necessary incident of carrying on the company's business, but a non-trading company, for instance, a company formed to promote art, science, religion or charity, has no implied borrowing power. It has been found, however, that an implied power of borrowing, even when it attaches, is too inconvenient to be relied on in practice, and an express power is always now inserted in the memorandum. A company cannot exercise any borrowing power until it has become entitled to commencing business.

✓ The object clause of the memorandum of association of a company gives it power to borrow and the articles of association contain the regulations by which this "power" is

to be exercised. The borrowing power may be vested in the company in a general meeting, or in the directors. The directors are usually authorised by the articles to borrow up to a certain limit which is usually not more than the share capital of the company. When the directors want to borrow more than the limit named, they have to take the permission of the company in a general meeting. To ascertain and determine the nature and limit of a company's borrowing power, and the extent to which the directors are authorised to act upon their own responsibility an inspection of the company's memorandum and articles of association is necessary.

A company proposing to borrow usually issues a prospectus, stating the amount of issue, the dates for payment, the particulars of the property comprised in the security, the terms as to redemption, and so on, and inviting the public to subscribe. Underwriting is also resorted to, as in the case of shares, to ensure that the issue is taken up. A debenture may be either (1) a simple promise to pay or a "naked" debenture given under the seal of the company and without any charge upon the company's assets, the holders being simply ordinary unsecured creditors, or (2) a promise to pay, secured by mortgage or charge upon the whole or part of a company's assets. Debentures of the latter class are termed Mortgage Debentures or Mortgage Bonds. The property constituting the security may be vested in Trustees, and held by them for the debenture holders, who become the virtual owners of the property, and no dealing with it, or change in its constitution can be effected without their consent. In other cases debentures are secured by a floating charge or general lien upon the undertaking of a company. Companies may give a specific charge over the immovable assets, *viz.*,



land and buildings, etc.; a floating charge over the movable assets such as, stock-in-trade, book debts, and investments or both. In the case of a fixed or specific charge, the company cannot deal with property covered by it. A floating charge is an equitable mortgage or charge upon a company's property generally to secure the repayment of moneys advanced (usually upon mortgage debentures). The charge is "floating" or "suspended" until the happening of certain events named in the mortgage-deed, *e.g.*, the company ceasing to carry on business, failure to pay interest, etc., when the charge "crystallises" and attaches to the property. In that event a receiver or manager is appointed on behalf of the debenture-holders. In the meantime, the company has full power to deal with the assets in the ordinary way of business; and, accordingly, the nature and value of the assets will vary from time to time.

All debenture-holders are creditors of the company, and, even if they are unsecured, they are always entitled to payments in full before shareholders of any class. The interest payable upon debentures is a charge upon the company and it must be paid whether a company makes a profit or not, but it is not so with the dividend on shares which is an appropriation of profits.

Like shares debentures are issued in denominations but unlike them they are issued in more than one denominations such as Rs. 100, Rs. 500, Rs. 1,000, etc. Debentures can also be issued in the form of stock and then they are called debenture stocks. These should not be confused with shares and are called stock because they are issued in the form of stock. Debentures are also issued in more than one series, termed successively First, Second and Third Debentures. These rank in security according to priority of issue. If

the company goes into liquidation, the first debenture-holders must be satisfied in full before the second debenture-holders, and the second debenture-holders before the third. Debentures may be issued either as registered debentures or as debentures to bearer in the same way as shares. The company has to maintain a register of debenture-holders, the names of the registered holders are transferable by executing the usual transfer form and the repayment at maturity is made only to the registered holder. Debentures to bearer have coupons attached for periodical payments of interest. These are "negotiable instruments" as they are transferable by mere delivery, and a *bona fide* transferee for value obtains an indefeasible title "free from the equities."

#### **Redeemable and Irredeemable Debentures.—**

Debentures issued by companies are either redeemable or irredeemable. Redeemable debentures are those which can be returned or paid off by the company on or after a certain date. Irredeemable debentures are those which cannot be paid off and cancelled. In the case of redeemable debentures provision is made for their redemption or payment by setting aside a portion of the annual profits into a sinking fund. The entire issue is either paid off in one instalment or by stages, and in the latter case a number of debentures are drawn by lot. Companies sometimes arrange to pay off one series of debentures by utilising the proceeds derived from a new issue of debentures.

**Terms of Issue.**—Debentures may be issued (1) at par, (2) at a discount or (3) at a premium. If the nominal or face value of a debenture is Rs. 100, and the subscribers pay the full face value, that is, Rs. 100 for each, the debenture is said to be issued at par; if it is offered for less than the nominal value, say, for Rs. 98 each, it is said to be issued

at a discount; and if it is offered for more than the nominal value and the subscribers pay, say, Rs. 102 for each, it is said to be issued at a premium. Similarly, a debenture is redeemable at par, if for every Rs. 100 debenture the company has to pay Rs. 100 to cancel it; and redeemable at a premium, if for every Rs. 100 debenture the company has to pay Rs. 102. The premium received on an issue of debentures is usually, as in the case of the premium received on shares, transferred to a special reserve account, and not treated as profit. Where they are issued at a discount, the amount of the discount is written off by equal annual transfers to the profit and loss account. Shares are also issued at par or at a premium. Formerly, these could not be issued at a discount, but the Amendment Act, 1936, has provided that a company can issue shares at a discount under certain conditions. This has already been discussed on page 166.

**Registration of Mortgages.**—According to Section 109 of the Indian Companies Act, 1913, it is compulsory for every company to register with the Registrar of companies (a) every mortgage or charge for the purpose of securing the issue of debentures, and (b) a floating charge on the undertaking or the property of the company, within 21 days after the date of its creation. Failure to do so makes the mortgage charge void against the liquidator and any creditor of the company. Other kinds of debentures need not be registered and they will be valid without it. The following mortgages or charges must be registered:—

- (a) a mortgage or charge for the purpose of securing any issue of debentures;
- (b) a mortgage or charge on uncalled share capital of the company;

- (c) a mortgage or charge on any immovable property wherever situate or any interest therein;
- (d) a mortgage or charge on any book debts of the company;
- (e) a mortgage or charge, not being a pledge, on any movable property of the company, except stock-in-trade;
- (f) a floating charge on the undertaking or property of the company.

It is provided that where a mortgage or charge requires to be registered has been so registered, any person acquiring such property or any part thereof, shall be deemed to have notice of the mortgage or charge, as from the date of such registration. The clause (e) has been added by the 1936 Act, and, it implies that a mortgage or charge other than a pledge, on any movable property of the company except stock-in-trade, shall, as regards security, be void against the liquidator and any creditor, unless the mortgage or charge is registered as required by this section.

It is also provided that any person acquiring such property is deemed to have notice of the mortgage or charge if the same has been duly registered as required by this section.

It is further provided that if a mortgage or charge is not registered, it shall not prejudice any contract or obligation for the repayment of money thereby secured, and when a mortgage or charge becomes void under this section, the money secured thereby shall be immediately payable.

Where a negotiable instrument has been given to

secure the payment of any book debts of a company, the deposit of the instrument for the purpose of securing an advance to the company, shall not, for the purpose of this section, be regarded as a mortgage or charge on those book debts.

Holding of debentures entitling the holder to a charge on immovable property shall not be deemed to be an interest in immovable property.

According to Section 116 the registration can be effected by the company on filing with the Registrar the prescribed particulars of every mortgage or charge created by the company, and of the issue of debentures of a series, which are required to be registered under Section 109. Such a registration can be effected on the application of any person interested therein.

#### **Register and Index of Mortgages and Charges.—**

By Section 112 of the Act the Registrar is required to keep, with respect to each company, a register in the prescribed form of all mortgages and charges created by the company after the commencement of the Act and requiring registration under Section 109, and shall, on payment of the prescribed fee, enter therein, with respect to each such mortgage or charge, the date of creation, the amount secured by it, short particulars of the property mortgaged or charged, and the names of the mortgagees or persons entitled to the charge. After making the above entries, the Registrar must return the instrument or its verified copy, as the case may be, filed with him, to the person who had filed it. The register shall be open to inspection by any person on payment of the prescribed fee, not exceeding a rupee for each inspection. Section 213 requires a chronological index to be maintained by the Registrar in the prescribed form and with the

prescribed particulars, of the mortgages and charges registered by him under this Act.

**Company's Register of Mortgages.**—Section 123 requires every company to maintain a register of mortgages and to enter therein all mortgages and charges specifically affecting the property of the company and all floating charges on the undertaking or any property of the company, giving in each case a short description of the property charged, the amount of the mortgage or charge and (except in the case of securities payable to bearer) the names of the mortgagees and chargees. Failing to maintain such a register, the directors, managers and other officers of the company responsible for the same are liable to a fine up to Rs. 500. It is important to note here that this register is different from the one kept by the Registrar under Section 112. There is a difference in their contents also because in the company's register all mortgages must be entered.

Section 124 provides that copies of the instruments creating mortgages and charges kept at the registered office of the company as required by Section 117 and the register of the mortgages kept by the company under Section 123 stated above, shall be open, at all reasonable times, to inspection by any creditor or member, without fee. The register shall be open for inspection by outsiders also on payment of a fee, not exceeding a rupee, as may be prescribed by the company. Similarly, Section 125 lays down that all registered debenture-holders and shareholders of the company must be given facilities to inspect the register of the debenture-holders of a company.

**Scrip.**—This is a term applied to the bond or certificate denoting a person's holding in any loan or in the capital of any joint-stock company. It is also the name given to the

provisional certificate issued in the case of a Government, Corporation, or other loan until such time as the definitive bond or certificate is ready. A subscriber whose application is successful receives a letter of allotment, which is changed for a "scrip certificate" on payment of the first instalment. After all the instalments have been paid, the scrip certificate is exchangeable for a definitive bond or certificate. The expression is used in a general way by Stock Exchange members and the clerks to denote securities to bearer.

## Section 5—Directors

**Appointment of Directors.**—The number of the directors and the names of the first directors of a company are usually given in the articles. The appointment of the persons named in the articles cannot be valid unless each of the proposed directors has:—

- (a) signed and delivered to the Registrar his consent to act as director; and
- (b) either (i) signed the memorandum for his qualification shares; or (ii) taken up or paid for them; or (iii) signed and filed with the Registrar a contract to take them from the company and pay for them; or (iv) signed and filed with the Registrar a declaration that a number of shares sufficient to qualify him are registered in his name. (Section 84.)

If the names are not given in the articles, Section 83B (1) (i) of the Act provides that the subscribers to the memorandum shall be deemed to be directors of the company until the first directors shall have been appointed. The subscribers in such a case generally meet to appoint the first directors, or the appointment can be made in writing signed by all the subscribers.

The articles also provide the mode of appointing subsequent directors. If there be no such specific provision, Section 83B (i), (ii), (iii) lays down that the directors shall be appointed by the members in the general meeting. A casual vacancy occurring among the directors, may be filled



up by the remaining directors; but the person so appointed shall be subject to retirement at the time when the person in whose place he has been appointed would have been liable to retire.

A new rule has been introduced by the Amending Act of 1936 with regard to the appointment of directors. Section 83B Sub-Section (2) provides that, notwithstanding any provisions in the articles to the contrary, not less than two-thirds of the total number of directors appointed by the company at any time, shall be subject to retirement by rotation. It is thus clear that a company can appoint permanent directors but these cannot be more than one-third of the total number of directors. Formerly there was no legal restriction in the number of permanent directors which a public company could appoint so long as it was provided in the articles of the company. This rule does not apply to private companies and to companies incorporated before the commencement (15th January, 1937) of the operation of the Indian Companies (Amendment) Act, 1936, if their articles provide that less than two-thirds of their directors shall be liable to retirement by rotation.

The methods of appointment of directors may be summarised as follows:—

1. By specific appointment in the articles. (Section 84.)
2. By a majority of the subscribers to the memorandum. (Regulation 68 of Table A.)
3. By subscribing in the memorandum of association. (Section 83B.)
4. By the shareholders in the general meeting. (Section 83B.)

5. By making provision in the articles giving the directors power to elect additional directors or to fill casual vacancies in the directorate. (Section 83B and Regulations 84 and 85 of Table A.)

**Qualification of Directors.**—When the articles of a company provide that its directors should hold a certain number of qualification shares, it shall be the duty of every director, who is not already qualified, to obtain his qualification shares within two months of his appointment, or such shorter time as may be fixed by the articles. (Section 85.) Articles usually provide that the directors should hold these shares *in their own right*. It is, therefore, permissible for a director to hold shares as trustee for another. No company can, however, commence business until ~~each director~~ <sup>each director</sup> has taken up his qualification shares and paid for them. (Section 103.)

**Disqualifications of Directors.**—

1. If he fails to take the qualification shares stated above.
2. If he holds the qualification shares at the time of his appointment, but subsequently ceases to hold them. (Section 86I.)
3. An insolvent cannot be appointed director of a company, and a director ceases to be so when he is declared insolvent because a bankrupt cannot be said to be holding shares in his own right as his estate is vested in the hands of the trustee in Bankruptcy. (Section 86A.)

It is important to note here that all acts of a director are valid notwithstanding any defect that may be discovered

subsequently in his appointment or his qualification. No acts of a director, however, can be valid after it has been shown that his appointment is invalid. (Section 86.)

**Rotation of Directors.**—The directors of a company are usually elected and are subject to retirement by rotation. It is, however, permissible for a company to have a few nominated directors who are not subject to rotation, but they must fulfil the conditions and qualifications required of directors. Where there are permanent directors in a company, not less than two-thirds of the total number of directors must be subject to retirement and one-third of them should retire every year in rotation. Regulations 78—82 of Table A, which are compulsory for all public companies, define the method and procedure of rotation of directors.

The first set of directors, called the 'proposed directors,' are appointed either by the articles of the company or by the subscribers to the memorandum as explained before, and continue as directors till the first ordinary meeting of the company which is held after one year and before eighteen months from the date of the incorporation of the company. (Section 76.) At this meeting it is compulsory for all the directors of a public company to retire from office, and usually all are re-elected. At the ordinary meeting in every subsequent year, one-third of the directors for the time being or, if their number is not three or a multiple of three, then the number nearest to one-third shall retire from office. (Regulation 78.) The directors to retire in every year shall be those who have been longest in office since their last election, but as between persons who became directors on the same day, those to retire shall (unless they otherwise agree among themselves) be determined by lot (Regulation 79).

A retiring director shall be eligible for re-election. (Regulation 80.) The company, at the general meeting at which a director retires in the above manner, may fill up the vacancy by electing a person thereto. (Regulation 81.) If the places of retiring directors are not filled up at the general meeting, the meeting shall stand adjourned till the same day in the next week, at the same time and place, and, if at the adjourned meeting the places of the vacating directors are not filled up, the vacating directors or such of them as have not had their places filled up shall be deemed to have been re-elected at the adjourned meeting. (Regulation 82.)

The regulations about the retirement and rotation of directors are not obligatory on a private company. A private company may, by its own articles, avoid completely the rotation of directors or it may make other provisions for such rotation. (Act II of 1938.)

**Powers and Duties of Directors.**—The powers and functions of a company are governed by its memorandum of association and those of the directors by its articles. The articles may give special powers to one or more directors who may be called managing director (or directors) or manager for such term and at such remuneration (salary, commission or both) as they may think fit, and a director so appointed shall not, while holding that office, be subject to retirement by rotation; but his appointment shall be subject to determination *ipso facto* if he ceases from any cause to be a director, or if the company in general meeting resolves that his term of office of managing director or manager be determined. (Regulation 72, Table A.) The articles should give the powers of the directors in detail. Any undue restriction may hinder the smooth and efficient working of the company and may necessitate the calling of meetings of

shareholders which may result in delay and expense. If the directors of a company do something which they are not permitted to do by the articles of the company, they will be exceeding their powers and the act will be *ultra vires*, but the shareholders may subsequently ratify the act of the directors provided it is *intra vires* the company, that is, the company is permitted by its memorandum to do the work. The object clause of the memorandum of association defines and limits the powers or the activities of the company and if the directors do something which is not given in the object clause of the memorandum it will be *ultra vires* the company, that is, beyond the powers of the company. Such an act of the directors is absolutely void and cannot be validated by any subsequent act, not even by an unanimous resolution of all the shareholders. When the directors enter into a transaction with a third party and the transaction is *ultra vires* the company, the third party can have no remedy against the company. It may be possible for him to have a remedy against the directors personally, in case they have committed fraud, or misrepresentation in inducing him to enter into the transaction. This is the reason why persons dealing with a company must inquire into the contents of the memorandum and the articles of the company. Law has, therefore, made it compulsory for every company to register these two documents with the Registrar of companies. These are public documents and can be inspected by any one on payment of a certain fee. No outsider can, therefore, say that he was not aware of the contents of the memorandum or of the articles because it is the duty of every person to look into the memorandum and the articles when dealing with the company.

There may be other acts of the directors which are within the powers of the company, but they may not be within

the powers of the directors till certain conditions, as laid down by the articles of the company, are fulfilled. For instance, a company may have the power to mortgage its property and issue debentures provided the directors get a special resolution passed to that effect. If the debentures are issued without the special resolution, such an act is *ultra vires* the directors but *intra vires* the company. In such a case it is permissible for the directors to get their action subsequently ratified by adopting the required resolution and thereby making it binding on the company. Even if the above resolution is not adopted, the company is liable for the acts of its directors because outsiders may have no reason to believe that the required condition has not been fulfilled by the directors. Further, they are not bound to inquire and will not, therefore, be presumed to know whether all the regulations of the company, relating to its internal management and the conduct of its business, have been duly and properly complied with. The creditor is entitled to presume that the necessary resolution was passed, because resolutions are matters of internal management of a company and an outsider will not be fixed with a notice of any irregularity therein. There are certain exceptions to this rule and the company will not be bound by the acts of their directors under the following circumstances:—

1. Where an outsider has a notice of the irregularity, it does not matter if the irregularity is in connection with the internal management. If the company, however, derives benefit from it, it will be required to pay for the same.
2. Where the directors enter into a fraudulent arrangement or agreement with others, it will not be binding on the company, if the other was actually a party to the fraud.

A fraudulent misrepresentation, however, by a director or other agents of the company in the course of his or their business, will be binding on the company, and the fraud or misrepresentation need not be for the benefit of the company, but may have been made by the agents for their own benefit.<sup>1</sup>

3. Where an act is a forgery it will not bind the company.

The directors must exercise their powers with due diligence and should use their best judgment in all their activities. They are not responsible for any loss to the company caused through mere error of judgment unless it be one of gross negligence. The directors generally select the staff of the company and decide what dividend, if any, is to be paid. The first auditors of the company are appointed<sup>2</sup> by the directors and any casual vacancy is filled<sup>3</sup> by them, subject to the confirmation by the shareholders at the general meeting.

### **Restrictions and Disabilities of Directors.—**

1. **Ineligibility of a Bankrupt to act as Director.**—An undischarged insolvent must not act as a director (or manager or managing agent) of any company including a company incorporated outside British India but having a place of business in British India. If such a person acts as a director etc., he shall be liable to imprisonment up to two years, or to a fine up to one thousand rupees, or to both. (Section 86A.)

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<sup>1</sup> Decision of the House of Lords in *Lloyd vs. Grace Smith & Co.* (1912), A.C. 716.

<sup>2</sup> Indian Companies Act, 1913, Section 144(7).

<sup>3</sup> Indian Companies Act, 1913, Section 144(8).

2. **Assignment of Office of Directors.**—The practice of assigning office by directors under powers given to them in the articles of association became most frequent in England. This privilege was often abused. The matter was brought before the Green Committee in 1925-26 and they were of opinion that this practice was not very desirable. Accordingly the English Act was changed in 1929 following which a similar change was effected in the Indian Companies Act, 1936. The new Act prohibits every director or manager of a company from assigning his office to another person unless and until it is sanctioned by a special resolution of the company. The assignment will be invalid even if it is provided in the articles of the company, or there be an agreement to that effect. If a director appoints an alternate or substitute director to act for him during his absence from the district in which the meetings of directors are ordinarily held, it shall not be deemed to be an assignment of office, provided the absence is for not less than three months and the approval of the board of directors has been obtained. The alternate director shall *ipso facto* vacate office on the original director returning to the district in question. (Section 86B.)

3. **Exemption of Directors from Liability to Company.**—The articles of a company often contain provisions exempting directors and other officers of the company from liability, either absolutely or to a limited extent. Such provisions are known as “indemnity clauses.” The Amending Act of 1936, however, has now remedied this defect by Section 86C which provides that, except as provided under the section, any provision contained in the articles or in any contract with a company or otherwise, for exempting any director, manager, or officer or auditor of the company from, or indemnifying him against, any liability, which, by



law, would otherwise attach to him, in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company, shall be void. In the case of a company which has these provisions on the date of the commencement of the Amending Act of 1936, this section shall come into operation six months after such date. This section shall not deprive a person of any exemption or right of indemnity for anything done so long as such provision was in force. Notwithstanding anything in this section, a company may, in pursuance of such indemnity clause, indemnify any such director, manager, officer or auditor against any liability incurred by him in defending any proceeding, whether civil or criminal, provided it terminated in his favour, or in connection with an application under Section 281 of this Act in which relief is granted by the court. ✓

4. **Loans to Directors.**—Directors often took loans from companies of which they were directors. This practice almost became a scandal and the Bombay Shareholders' Association and other public bodies protested against it. Section 86D of the Indian Companies (Amendment) Act, 1936, definitely forbids loans of any kind to a director *other than the directors of a banking or a private company*. No company is now permitted to make any loan or guarantee any loan made to a director of the company or to a firm of which such director is a partner or to a private company of which such director is member or director. Contravention of the above rule will make the director or directors guilty of such act and liable to a fine up to rupees five hundred, and further, the directors shall be responsible jointly and severally for any portion of the loan unrealised. It is important to note here that loans by one public company to

another in which there are common directors are not prohibited. It will be better if provision is made for the disclosure of such loans in the balance-sheet as is necessary in the case of insurance companies.

**5. Director not to Hold Office of Profit.**—No director or firm of which such director is a partner or private company of which such director is a director shall, without the consent of the company in the general meeting, hold any office of profit under the company except that of a managing director or manager or managing agent or a legal or technical adviser or a banker. A director appointed before the commencement of the Indian Companies (Amendment) Act, 1936, to any office of profit under the company is exempted, (Section 86E.)

**6. Directors Trading Contract with the Company.**—The following persons shall not enter into any trading contract for the sale, purchase or supply of goods and materials with the company without the sanction of the directors<sup>4</sup>:—

- (i) a director of a company;
- (ii) a firm of which a partner is a director of the company;
- (iii) a partner of such a firm; and
- (iv) a private company of which a member or director is a director of the company.

This restriction applies to all companies, public and private. It will, however, not affect the contracts or agreements made before the commencement of the Amending Act of 1936(15th January, 1937).

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<sup>4</sup> Indian Companies (Amendment) Act, 1936, Section 86F.

**7. Disclosure of Interest by Directors.**—Every director must disclose the nature of his interest in any contract or arrangement entered into for or on behalf of the company, at the meeting of the directors at which such contract or arrangement is to be determined on, if his interest then exists, or in any other case at the first meeting of the directors after the acquisition of his interest or the making of the contract or arrangement (Section 91A). Contravention of this rule shall make the director liable to a fine not exceeding one thousand rupees.

Section 91A requires the maintenance of a register of contracts or arrangements in which any director is directly or indirectly interested. This register is open to inspection by the members of the company. It is apprehended by the management that this will disclose the secrets of the business to rival institutions. As, however, all contracts have not been mentioned in the register, but only those in which the directors are interested, the apprehension will not materialise to any very great extent.

**8. Prohibition of Voting by Interested Directors.**—A director shall not vote on any contract or arrangement in which he is directly or indirectly interested, and if he gives vote, his vote shall not be counted. His presence, too, shall not, in such a case, be counted for the purpose of forming a quorum. (Section 91B.) This section shall not apply to a private company.

**9. Directors' Interest in the Appointment of Manager or Managing Agent.**—Where a director is interested in any contract appointing a manager or managing agent, the company shall, within twenty-one days of the contract, send an abstract of the terms of the contract, together with a memorandum, clearly indicating to the members the

interest of the director in the contract. The contract shall also be kept open for inspection of members at the registered office of the company. (Section 91C.) Contravention of this rule shall make the company and also the directors liable to a fine not exceeding rupees one thousand.

**10. Contract by Directors as Agents on Behalf of the Company.**—If a director, as agent of the company, enters into a contract for or on behalf of the company in his own name, he must make a memorandum of such contract in writing and forthwith deliver the same to the company. Such a memorandum must be filed by the company and laid before the directors at their next meeting. In case of contravention the contract shall, at the option of the company, be void as against the company, and such director (or manager or any other agent) shall be liable to a fine not exceeding rupees two hundred. This section does not apply to a private company. (Section 91D.)

**11. Restrictions on Powers of Directors.**—Regulation 71 of Table A, which is compulsory for all companies, lays down that the business of a company shall be managed by the directors except that part of the business which is to be managed by the company, as required by its articles. Section 86H of the Amending Act, however, imposes certain restrictions on the powers of the directors of a public company, as it provides that the directors of a company shall not sell or dispose of the undertaking of the company, or remit any debt due by a director, except with the consent of the company concerned at a general meeting.

**12. Removal of Directors.**—It has now become possible for a company to remove a director from office, if for any reason such removal is desired by the company. Section 86G provides that a company may, by an extra-

ordinary resolution, remove any director who is subject to retirement by rotation before the expiration of his period of office, and may appoint another in his place by an ordinary resolution, but he shall hold office only for the remaining period of rotation. A director so removed shall not be re-appointed by the board of directors. This rule does not apply to directors elected before the Amending Act of 1936 came into force and it does not apply to permanent directors.

**Vacation of Office by Directors.**—The office of a director shall be vacated, if<sup>5</sup>:—

- (a) he fails to obtain within two months of his appointment, or such shorter time as may be fixed by the articles, the required minimum share qualification, or any time thereafter ceases to hold, the share qualification, if any, necessary for his appointment, or
- (b) he is found by a court to be of unsound mind, or
- (c) he is adjudged an insolvent, or
- (d) he fails to pay calls within six months of calls being made, or
- (e) he or any firm of which he is a partner or any private company of which he is a director, without the sanction of the company in general meeting accepts or holds any office of profit under the company other than that of a managing director or manager or managing agent or a legal or technical adviser or a banker (Section 86E), or

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<sup>5</sup> Indian Companies (Amendment) Act, 1936. Section 86I.

- (f) he absents himself from three consecutive meetings of the directors or from all meetings of the directors for a continuous period of three months, whichever is longer, without leave of absence from the board of directors, or
- (g) he or any firm of which he is a partner or any private company of which he is a director accepts a loan or guarantee from the company in contravention of Section 86D, or
- (h) he enters into a trading contract with a company in contravention of Section 86F.

These are statutory grounds on the happening of which a director must vacate his office. The Act does not prohibit a company from providing in its articles other grounds for vacating the office of directors.

**Register of Directors, Managers and Managing Agents.**—Every company shall keep at its registered office a register of its directors (managers and managing agents) containing the following particulars<sup>6</sup>:—

- (a) in the case of an individual, his present name in full, any former name or surname in full, his usual residential address, his nationality and the nationality of his origin if that is different from his present one, his business occupation (if any), and if he holds any other directorship or directorships, the particulars of the same;
- (b) in the case of a corporation, its corporate name, its registered or principal office, and the full

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<sup>6</sup> Indian Companies Act 1913, Section 87.

name, address and nationality of each of its directors; and

- (c) in the case of a firm, the full name, address and nationality of each partner, and the date on which each became a partner. (Section 87.)

It is also provided that within fourteen days from the appointment of the first directors of the company and within a similar time of the subsequent change in the director (manager or managing agent), or in any particulars about them, the company shall send to the Registrar, a return in the prescribed form containing all the particulars given in the register.

The register must be kept open for at least two hours each day during business hours for the inspection of the members of the company and others. No fee is to be charged from the members, but the articles of the company may provide a fee not exceeding one rupee from outsiders.

**Liability of Directors.**—The liability of directors for their acts may be divided into three classes:—

- (i) liability to the company;
- (ii) liability to outsiders for their acts as directors or for the acts of the company;
- (iii) liability to shareholders.

**Liability of the Directors to the Company.**—

Directors may become liable to the company in various ways, such as (a) for gross negligence, (b) for breach of trust, (c) for acts which are *ultra vires*, (d) for unlimited liability, (e) for criminal acts.

(a) **For Gross Negligence.**—The rule is that so long as an act of the directors is within their powers, they

will not be held liable for mistakes or errors of judgment, even if there be loss to the company, provided they have acted *bona fide*, for the benefit of the company, and with reasonable care. In such a case the person challenging the act of the directors has to prove bad faith on the part of the directors. Section 281 of the Indian Companies Act, 1913, gives additional protection to the directors by providing that if, in any proceedings against the director of a company for negligence or breach of trust, it appears to the court that the director is, or may be, liable for negligence or breach of trust but has acted honestly and reasonably and ought fairly to be excused for negligence or breach of trust, the court may relieve him wholly or in part, from his liability, on such terms as the court may think proper. Section 281, however, does not give protection to a director for gross negligence, *unless the articles otherwise provide*. "Gross negligence" means "the failure to use the care of an ordinary person in his own affairs."

(b) **For Breach of Trust.**—Directors may be liable to the company for breach of trust by them for secret or illegitimate profits, for bonuses improperly paid to them, and for selling their own property to the company. The protection of Section 281 applies to cases of breach of trust also.

(c) **For Acts which are Ultra Vires.**—Directors know or ought to know that there are certain acts which they are not allowed to do and the performance of such acts is *ultra vires* the company. For instance, payment of dividend out of capital is prohibited by law.<sup>7</sup> When directors pay dividends out of capital and the company thereby suffers a

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<sup>7</sup> Regulation 97 of Table A. It is compulsory for all companies.



loss the directors are to compensate the company for it. They are liable even when the payment has been sanctioned by a majority of the shareholders. The protection of Section 281 applies also to cases of acts which are *ultra vires*.

(d) **Unlimited Liability of Directors.**—The liability of one or more directors of a limited company may be unlimited if it is provided in its memorandum. In such a case, it is the duty of the promoter and officers of the company to inform in writing the person appointed or elected and before he accepts the office or acts therein, that his liability will be unlimited. (Section 70.)

Under Section 157, a director, whether past or present, whose liability is unlimited, shall, on winding-up, be liable, in addition to his liability, if any, to contribute, as an ordinary member, to make a further contribution, as if he were, at the commencement of the winding-up, a member of an unlimited company, subject to the following rules:—

- (i) a past director shall not be liable to make such a contribution, if he has ceased to hold such office for a year or upwards before the commencement of the winding-up;
- (ii) he shall not be liable to so contribute for any debt incurred after he ceased to be a director;
- (iii) subject to the articles, he shall not be so liable unless the court deems it necessary to require the contribution for satisfying the debts of the company and the costs, charges and expenses of the winding-up.

It is important to note here that a director is not responsible for the acts or defaults of his co-directors, unless he has expressly or by implication authorised them. Where

the directors are liable, their liability is joint and several, and if one of the directors is made to pay, he is entitled to claim contribution from the others, unless he alone has been guilty of fraud. It is also important to note that the liability for breach of trust survives on the death of a director, while the liability for negligence does not, unless the moneys can be traced in the hands of the representatives.

**(e) For Criminal Liability of Directors.—**

Directors of a company are required by law to do certain acts and are similarly prohibited to do others. A default in either case will make them liable either to a fine or imprisonment as provided in the Act, and is dependent on the nature of the offence. For instance, Section 31 requires that the directors should keep a register of members. Section 82 requires that copies of special and extraordinary resolutions should be sent to the Registrar of Joint-Stock Companies, and non-compliance of this will make the directors liable to a fine. Again, Section 236 provides that falsification of accounts and books will make the directors liable to imprisonment.

The different sections are:—

1. Section 31—Keeping register of members.
2. Section 32—Annual list of members and summary.
3. Section 51—Notice to Registrar of conversion of shares and stocks.
4. Section 76—Calling the annual general meeting.
5. Section 82—Registration of copies of special and extraordinary resolutions.
6. Section 87—Keeping register of directors, managers and managing agents.

7. Section 104—Return of allotments.
8. Section 108—Limitation of time for issue of certificates.
9. Section 124—Keeping register of mortgages and charges and allowing inspection thereof.
10. Sections 236, 237, 238 and 238A—Penalty for falsification of books, prosecution of delinquent directors, penalty for giving false evidence, for not discovering the company's property or not handing over the company's documents to the liquidator.
11. Sections 282, 282A and 282B—For false statement, for wrongful withholding of the property of the company, and for misapplication of the funds of the employees.

**Directors' Liability to Outsiders.**—The liability of directors with outsiders may be with regard to contracts or torts. In the case of contracts directors' liability is the same as that of agents under the Indian Contract Act. They are not personally liable for contracts which they make on behalf of the company, unless such contracts are made in their own name. If made on behalf of the company they are not liable even if the contracts are *ultra vires* the company, for every person who contracts with the company is bound to read its memorandum. Where they hold out a warranty of authority, they may be liable for breach of warranty. As regards torts, the rule that whoever commits a wrong is liable for it himself, applies to directors as much as to other

persons. A director is not liable for the fraud of his co-directors, unless he himself was a party to it or authorised it.

If the prospectus contains false statements and people purchase shares on the faith of that statement the directors may become liable to such subscribers. Directors may also become liable to persons from whom they borrow money in case the loan is in excess of the borrowing powers of the company.

**Directors' Liability to Shareholders.**—Except in the case of frauds and acts which are *ultra vires* no shareholder has any right of action against a director or directors for wrong caused to him by the company.

**Misfeasance.**—A director must also bear in mind that the funds of the company are entrusted to the directors, for the objects of the company as defined by the company's memorandum of association and authorised by the general law, and that they must not be diverted from those objects or applied to purposes which are outside the objects of the company (*ultra vires*), or outside the powers of management given to the directors. This does not abridge the large discretion allowed to directors in carrying on the business of the company. The funds embarked in a trading company are intended to be employed for the acquisition of gain, and risk, greater or less according to circumstances, is necessarily incidental to such employment; but it is quite another matter when directors pay dividends out of capital, or return capital to the shareholders, or spend money of the company in "rigging" the market, or in buying the company's shares, or paying commission for underwriting the shares of the company, except to the extent authorised by the articles and Companies Acts. Directors who in these or any other ways misapply the funds of the company are guilty of 'misfeasance'

(breach of trust), and all who join in the misapplication are jointly and severally liable to replace the sums so misapplied. The remedy of the company for misfeasance, if the company is a going concern, is by action against the delinquent directors; but when a company is being wound up, the legislature has provided a summary mode of proceeding, by which the liquidator, or any creditor or contributory of the company, may take out what is known as a misfeasance summons, to compel the delinquent director or officer to repay the misapplied moneys or make compensation. The court is, however, given a discretionary power to relieve a director from liability if he has acted honestly and reasonably and ought fairly to be excused.

**Position of Directors.**—It is often asked what exactly is the legal position of directors. Are they agents, trustees or managing partners? From the discussions to follow readers will find that it is difficult to describe the exact position of directors. They have power and control over a company and they manage its affairs. The question is the capacity in which they do it, whether as proprietors, agents or principals, the three alternative positions which they may be occupying. For the determination of their correct position we have to be guided in our analysis by the nature of the work which they have to perform as directors, and the power and position which the Companies Act has conferred on them.

Of the three forms of business organisation, in two the proprietors have the inherent right to manage a business. They have the choice to manage it themselves or by employee managers. When a business is managed by the proprietor, he is called a managing proprietor, if the business is an individual proprietorship, and a managing partner, if it is a

partnership. To be designated a managing proprietor or managing partner one must have an inherent right to manage the business as proprietor. Besides, the proprietor or proprietors of a firm always act as principals because law does not make any difference between a firm and its proprietor or proprietors. As a matter of fact, a firm has no separate existence or identity of its own apart from its owners. Consequently, all the acts of the proprietor of a firm are those of a principal. A joint-stock company, on the other hand, is a legal entity, it has an existence of its own apart from its proprietors who are called shareholders. The Companies Act does not give any power to the proprietors, *viz.*, the shareholders of a company, to manage its business as shareholders. By Regulation 71 of Table A, which is compulsory for all companies, the management of a company is in the hands of a group of persons, called directors, who are elected by the shareholders of the company from among themselves.<sup>8</sup> A director, therefore, does not manage a company as a proprietor, hence he cannot be called a managing proprietor or a managing partner.

If directors are not managing proprietors, what are they? Are they agents, and if they are agents, there must be a principal and who is the principal? Law recognises two kinds of persons, one natural and the other artificial, and it confers on every incorporated company an artificial personality. Accordingly a company is the owner of its property and in its relation with a third party, it can sue and be sued. It is thus evident that a company is the principal.

From the functions performed by the directors of a company, it can easily be inferred that some of their acts are

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<sup>8</sup> Regulation 78, Table A.

those of agents. For instance, they can enter into contract with third parties on behalf of the company without being personally liable for it. When directors act in excess of their authority, the company can, by subsequent resolution, ratify the act of the directors. The office of a director is that of a paid servant of the company. He never enters into a contract himself except for his principal. He cannot sue on such contracts, nor be sued for them, unless he exceeds his authority. It is only when the acts of directors are *ultra vires* the company that the company cannot ratify the act as explained before, nor can the company be made liable for such acts. The directors also cannot be made liable for these acts, because they merely acted as agents for a known principal. In such a case, they may be made liable as on a breach of warranty of authority. In all the above cases the position of the directors is that of an agent and the company is the principal.

But all their activities are not those of agents, because there are functions in which they act as principals. For example, the directors' power of approving transfers, issuing and allotting of shares, making calls, receiving money in advance of calls, forfeiting shares are instances when directors act as principals and not as agents and they are bound strictly to act in good faith towards the shareholders under these heads. One must be either a proprietor or a trustee to act as a principal. On those who are not proprietors law has conferred the status of principal on trustees. We are, therefore, led to the inevitable conclusion that in these activities directors act as trustees. A trustee has been defined as a man who is the owner of the property and deals with it as principal, as owner and as master, subject only to an equitable obligation to account to some persons to whom he

stands in relation of trustee.<sup>9</sup> The directors, with regard to the capital under their control, are in the position of trustees and are bound to deal with such capital as a trust.

If the directors of a company purchase shares of the same company from a shareholder, while they are negotiating for the sale of the company to another at a very high price and they do not disclose the fact to the shareholder, it is not a breach of trust. Directors are, therefore, not trustees for any individual shareholder, nor are they trustees for third persons who have made contracts with the company. A director is a trustee for the creditors of the company to this extent that he is bound to employ all the assets for the benefit of all the creditors of the company. If a director, who is also a creditor of the company, knowing fully well that the financial position of the company is such that it is soon bound to go into liquidation, and to avoid any personal loss of his dues as a creditor of the company, obtains hypothecation of the stock-in-trade and outstandings of the company, the transaction will be set aside on the ground of fraud. It is thus clear that in certain respects directors are trustees, while in other respects they are agents. As a matter of fact they stand in a fiduciary position towards the company in regard to powers conferred on them by the articles.

#### AUDITORS

##### **Appointment and Remuneration of Auditors.—**

Every company is required by Section 144 to appoint at each annual general meeting an auditor or auditors to hold office

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<sup>9</sup> *Handbook of Company Law* by R. H. Pandia, p. 111.



until the next annual general meeting. The remuneration of the auditor is fixed by the shareholders at the general meeting. The auditor or auditors appointed by a public company must be certified or Registered Auditors, though a private company can appoint anyone as an auditor.

Where there is default in appointing an auditor at an annual general meeting the Local Government may, on the application of any member of the company, appoint an auditor of the company for the current year and fix his remuneration.

With newly-formed companies, the directors are authorised to appoint auditors and fix their remuneration. Such auditors will hold office until the first annual general meeting, when they will be eligible for re-election. Shareholders may, however, remove them from office by a resolution passed at a general meeting and, in that event, may appoint other auditors at the same meeting.

The directors may also fill any casual vacancies, should any such arise; but the surviving (or continuing) auditors may act whilst such casual vacancy remains unfilled.

The following persons shall not be appointed auditors of a company:—

- (i) a director or officer of the company;
- (ii) a partner of such director or officer;
- (iii) in the case of a company other than a private company, not being the subsidiary company of a public company, any person in the employment of such director or officer;
- (iv) any person indebted to the company; and
- (v) if any person after being appointed auditor becomes indebted to the company his appointment shall, therefore, be terminated.

A person, other than a retiring auditor, shall not be capable of being appointed auditor at an annual general meeting unless notice of an intention to nominate that person to the office of auditor has been given by a member of the company to the company not less than fourteen days before the annual general meeting, and the company must send a copy of the notice to the retiring auditor and to the shareholders not less than seven days before the meeting.

An auditor appointed by the directors before the statutory meeting must retire before the first annual general meeting. He can stand for election or reappointment but he is not entitled to a notice as is necessary in the case of auditors appointed at the first annual general meeting or thereafter. At the first annual general meeting another auditor may be appointed without any notice being given to the previous one.

The remuneration of the auditors of a company shall be fixed by the company in the general meeting, except that the remuneration of any auditors appointed before the statutory meeting, or to fill any casual vacancy, may be fixed by the directors.

**Duties and Powers of Auditors.**—The powers and duties of auditors are defined by Section 145 of the Amending Act of 1936, and include:—

1. The right of access to the company's books, accounts, and vouchers.
2. The right to require all necessary information and explanation from the directors and officers of the company.
3. The right to receive notice of and to attend any general meeting of the company at which accounts examined or reported on by them

are laid before the company and to make any statements they wish.

A report on the accounts and every balance-sheet and profit and loss account must be made by the auditors and submitted to the company at the general meeting. The report shall state whether they have obtained all necessary information and explanations, whether the balance-sheet and profit and loss account are drawn up in conformity with the law, whether the balance-sheet shows, in their opinion, a true and correct view of the state of the company's affairs according to the best of their information and explanations, and as shown by the company's books, and whether in their opinion books of account have been kept by the company as required by Section 130.

A copy of the company's memorandum and articles of association must be made available to the auditors, who must satisfy themselves that the acts of, and payments authorised by, the directors are *intra vires* and within the scope of the company's powers as defined by the memorandum of association. Where any serious inaccuracies or unsatisfactory matters are disclosed, they must be dealt with in the auditors' report to the shareholders.

This report must be attached to the balance-sheet and the auditors are to be penalised for making a report not complying with the requirements of this section.

## ✓ Section 6—Dividends and Characteristics of Companies

**Dividends.**—Dividends are a certain proportion of a company's profits which are distributed to the shareholders, either by way of a percentage on the issued capital of the company or at a fixed sum per share. The manner in which these profits are divided among the members is determined by the memorandum and articles of association or, in some instances, where shares have been issued subsequent to the incorporation of the company, with certain preferential rights, by the special resolutions which created the shares. Regulations 95 to 102 of Table A deal with dividends and reserves.

Companies' articles often amplify these provisions to authorise the payment of dividends in specie, to confer greater powers on the directors with regard to reserves; and, where there are different classes of shares, to define the respective rights and priority to dividends, etc., *prima facie*, dividends must be paid in cash, unless the articles provide otherwise or the company in a general meeting passes special resolutions to alter the articles so as to vary the method of payment.

By regulation 95 of Table A, which is compulsory for all companies, the declaration of dividends is vested in the company in a general meeting, but no dividends shall exceed the amount recommended by the directors. Directors are usually authorised to declare interim dividends.

**Interim Dividends.**—Interim dividends are those dividends which are declared by the directors, and paid at intervals during the year, as a partial payment on account

of the year's profits pending production of the final accounts at the end of the year. Usually, they are paid shortly after the close of the first six months of a company's financial year.

Such dividends can only be declared and paid when the company's profits are sufficient to justify the payment and the articles of association confer authority upon the directors to distribute them. Although not usually published, companies almost invariably have half-yearly accounts prepared for the directors' information before the interim dividends are declared.

**Validity of Dividends.**—With the exception of the payment—in certain circumstances—of interest out of capital under the authority of Section 107 of the Indian Companies Act, 1913, and also the payment of interest on calls paid in advance as provided by Regulation 98 of Table A, the basic rule with regard to all dividends is that they shall not be paid out of capital: such payments, if made out of capital, are *ultra vires* and a breach of trust on the part of the directors authorising the payment. Even where the memorandum or articles of association authorise such a payment, or if the company passes a resolution sanctioning it, the payment would still be invalid, as it would, in effect, amount to an unauthorised and illegal reduction of capital. The directors are personally liable to replace the whole amount of any dividends so paid. Where, however, the directors innocently and in good faith relying on audited accounts and a *bona fide* valuation of the assets have paid dividends out of capital they are not responsible. This restriction imposed by Regulation 97 of Table A and compulsory for all companies is that “no dividends shall be paid otherwise than out of profits of the year or any other undistributed profits.”

The words "profits of the year" imply that dividends may be paid out of such profits, without writing off previous losses, if any. The words "any other undistributed profits" imply (i) that dividends may be paid out of profits (undistributed) of past years, even though the current year's working may show a loss, and (ii) that dividends need not be paid out of revenue profits only and may be paid out of capital profits as well. Thus there are three rules of importance to be observed with regard to dividends:—

(1) Dividends can be paid only out of profits; (2) they cannot be paid out of capital; and (3) dividends must be paid in cash and a shareholder is not bound to accept other shares or debentures in lieu thereof, unless there is an express agreement to that effect.

**Bonus Shares.**—When a company has accumulated a large amount of profits from its previous earnings, it may, provided the articles of the company permit it, capitalise the same by giving to the shareholders bonus shares in proportion to their holdings. The correct procedure is to declare a dividend or bonus out of its undistributed profits and at the same time to issue a corresponding number of new shares. The dividend or bonus declared in favour of the shareholders is applied in payment of those shares and the new shares will then belong to the shareholders as fully paid-up shares. The company will in this way capitalise its profits, *i.e.*, increase its capital by the issue, out of profits, of further new fully paid-up shares. This is the only way a company can issue bonus shares.

A company sometimes issues fully paid-up bonus shares directly and without declaring dividends or bonus, which procedure is considered to be of doubtful validity.

**Payment of Interest out of Capital.**—It has been stated before that Section 107 of the Indian Companies Act, 1913, empowers companies to pay interest on shares issued to provide the capital for the construction of works, buildings, or the provision of plant which cannot be made profitable for a lengthened period, during the period of such construction, etc., and may charge the interest as part of the cost of erection of works and buildings or the provision of the plant. The payment of interest is subject to the following conditions:—

1. Authorisation of the payment by the company's articles or by special resolution.
2. No such payment, whether authorised by the articles or by special resolution, shall be made without the previous sanction of the Local Government.
3. Such interest can be paid only during the period sanctioned by the Local Government, which must not extend beyond the half-year following that half-year in which works and buildings etc. are completed.
4. The rate of interest must not exceed 4 per cent per annum or such lower rate as the Governor General in Council may, by notification in the *Gazette of India*, prescribe.
5. The accounts of the company, from time to time, must show particulars of the share capital on which, and the rate at which the interest has been paid for the period shown in the accounts.

6. The payment of interest shall not operate as a reduction of the amount paid upon the shares in respect of which it is paid.

Nothing in this section shall affect any company to which the Indian Railway Companies Act, 1895, or the Indian Tramways Act, 1902, applies.

**Conversion of Private Company to Public Company.**—The procedure is governed by the provisions of Section 154 of the Companies Act, 1913, and also by Sections 20 and 82. The necessary steps to be taken are:—

1. The first step is the alteration of the articles of association of the company, which can be effected according to Section 20 by convening an extraordinary general meeting of the company and passing thereat special resolutions:—
  - (i) Authorising the company to become a public company.
  - (ii) Deleting from the company's articles of association the articles applicable only to private companies, *e.g.*, those articles that restrict the right of transfer, limit the total membership, and prohibit invitations to the public to subscribe for shares and debentures.
2. To file with the Registrar of Companies, printed copies of the special resolutions within fifteen days of their passing as required by Section 82.
3. To file a prospectus or a statement in lieu of prospectus.



4. If the total number of shareholders is less than seven, the directors must arrange for the necessary increase of membership.

As the company was already doing business, the filing of a declaration under Section 103 for obtaining a certificate to commence business is not necessary.

### **Conversion of a Public to a Private Company.—**

The Companies Act does not specify any procedure to be followed in the conversion of a public company into a private company, nor does it say whether such a conversion is permissible; but there is nothing in the Act against such a conversion. It will of course be necessary for the company to adopt and follow all the rules and regulations required by a private company. The company, therefore, must convene an extraordinary general meeting and pass special resolutions:—

1. To authorise the company to become a private company.
2. To delete from the articles of the association the inappropriate provisions, *e.g.*, articles relating to the issue of share-warrants to bearer, public issues of share capital or debentures, and unsuitable regulations relating to transfer or transmission of shares.
3. To insert in the articles of association new articles restricting the right to transfer the company's shares, restricting the total membership, and prohibiting invitations to the public to subscribe for shares or debentures.

If any share-warrants have been issued, they must be recalled and cancelled and definite share certificates issued in their place. If the total number of shareholders, exclusive of persons who are or were in the company's employment, is more than fifty, measures should be taken to reduce it to fifty or less.

After these measures have been taken and the company is brought in line with private companies and after the above resolutions have been passed and filed with the Registrar, the company will be able to claim the privileges of a private company.

**✓ A Comparison of Membership of a Company and of a Partnership.**—The partners of a partnership have all the powers of complete control over the property and assets of the partnership, and they have an inherent right in the management of its business, or affairs. In India there is no limited partnership, but in England and other countries where limited partnerships are permissible, the limited partners are in the position of "sleeping" partners and take no active part in the management. Members of a registered company, however, have only a limited form of control which they exercise at general meetings of the company in the following manner:—

1. The shareholders elect and fix the remuneration of the directors who manage and direct the company's business on behalf of its members.
2. Shareholders appoint and fix the remuneration of auditors, who examine the company's books and accounts, and report to the members on the accuracy of the balance-sheets submitted to them.

3. The directors submit their annual accounts and reports for the approval of shareholders. They also sanction the dividends proposed by the directors for distribution among the shareholders.
4. Alterations or revisions of the company's memorandum and articles of association can be effected with the approval of shareholders only.

Partners are agents of the firm, and the latter is bound by the acts of its members. Shareholders are not agents of the company and, individually, have no authority to bind the company by their acts.

**Characteristics of Investments.**—We have studied the characteristics of different classes of shares and debentures and have found that each class has its own advantages and disadvantages. Shares, bonds and debentures are commonly called securities. People who want to invest their money in one or the other or several of these securities are often faced with the problem of how to select them in order to obtain the best result and the maximum advantage. How should one approach the problem if such a person seeks advice?

It has been found that some people prefer to keep their money in fixed deposits at a bank, and others prefer purchasing government securities to securities of joint-stock companies, and among those who purchase the latter some prefer debentures, some preference shares, some ordinary shares and some deferred shares. Again, among the depositors at banks some prefer the Imperial Bank of India, in spite of the lower rate of interest it pays to its depositors, to any other banks in the country, because of the general feeling

that it is the safest bank, that it cannot fail, that at any rate, all the other banks in the country will fail before it fails. Even if the Imperial Bank of India were to stop payment of interest altogether there will still be many who will continue to deposit there, because they want, above all things, that their money should not be lost. To them the safety of the principal is the most important, the interest or the dividend only a secondary, consideration. There are others who say that there is nothing wrong with the other big banks in the country, that they are quite safe, that most of them have been working with success for the last fifty years or more and that they have not failed. Why should one not take advantage of the higher interest that they pay? But these very men will not approve of making deposits at a new or a less known bank or at one of doubtful position, even if it gives a still higher rate of interest, though there will always be some who will be lured by the very high rate of interest to make deposits at such a bank. The safety of the principal and the amount of return are, therefore, the two factors involved in investments. The more the safety, the less will the return be and the greater the return, the less the safety. All care for safety; but some give it the foremost position and others do not mind taking a little or a nominal risk for an extra gain. There are still others who will not mind taking a greater risk for a larger gain. The thrill of earning a large amount gives them a very great pleasure, in spite of the risk involved—the risk of losing the whole thing.

This is the general characteristic of human temperament and on this basis we can divide the investing public into three broad groups—cautious, moderate and speculative. Similarly, people prefer to purchase government bonds to

securities of companies, or debentures to shares, or preference shares to the ordinary, or ordinary shares to the deferred. The characteristics of securities are such that they can also be divided into three broad groups. Government bonds are the safest and so are also debentures of first-class companies. Next come debentures and preference shares of joint-stock companies; and also ordinary shares of very reliable and stable companies; and finally deferred and ordinary shares of some companies. This is the general division but it has to be modified according to circumstances. This does not mean that all deferred shares are speculative nor are all debentures and preference shares absolutely safe. It all depends upon the nature of the industry, on the competition in the industry, on the financial position of the company concerned and its management. I have explained before that preference shares of mining companies do not always warrant the same safety of the principal and certainty of income as similar shares of manufacturing and other stable companies. For the same reason deferred shares of mining companies are not so speculative either.

The basic temperament of the individual investor will act as a guide to him in the selection of securities for investment. A man of cautious temperament will go in for government bonds or, at the most, for first-class debentures; one who is speculative by nature will invest in deferred shares, particularly of mining and similar industries; and another of a moderate temperament will select preference shares or ordinary shares of very reliable companies. But at times, this instinctive impulse of temperament has to be changed or modified according to the circumstances surrounding an investor. For instance, the necessity of a definite income to meet daily expenses leaves no option to a specula-

tive investor but to be cautious and to invest in securities which are sure to give interest or dividend, at least to the extent of his requirement. Similarly, a wealthy man of a cautious temperament may be tempted to invest a part of his funds in speculative securities, because to a very rich man the value of money is not so great and he will not be worse off for a little loss.

In conclusion, we can say that temperament, the need of an immediate income, and the amount of money at one's disposal, all these three play an important part in the selection of securities by investors. This is the reason why people invest in two and sometimes in all the three groups; and all these factors are to be taken into consideration to give sound advice to one faced with the difficulty of arriving at a decision.

✓ **General Rules for Investments.**—There are certain general rules governing the course of trade and finance which should be known to every investor:—

1. The greater the yield, the greater the risk.
2. Where the rate of interest is fixed, a high yield means a low price; therefore, as the risk increases, the price falls.
3. Where money is scarce, interest rates rise, and prices fall.
4. Rising commodity prices mean active trade and high profits, but ultimately scarce money; and falling prices the reverse.
5. The capital value or yield on a share is not only its "money" value or yield, but depends also on the purchasing power of money. This and the preceding rule must be read together.

6. When trade is active and money in demand to the point of scarcity and high interest rates, government papers, war loans and similar gilt-edged fixed-interest stocks should be purchased, for these will be cheap under rule (2) and will improve under the second part of rule (4).
7. When trade is dull and money plentiful, one should buy ordinary shares whose value rises and falls with the course of business; these, provided the company is sound, will be cheap under rule (2), and will improve under the first part of rule (4).
8. Last and most important of all, one must lay a solid foundation. Life insurance comes first, and the sum assured must be increased, whenever the cost of living rises or the assured's standard of life improves.

### Characteristics of a Private Company:—

- ✓1. In a private company the number of members cannot be less than two and more than fifty, excluding employee and ex-employee shareholders. But when two or more persons hold shares jointly, they shall be treated as a single member.
- ✓2. In a private company there is a restriction in the right to transfer shares. Shares are transferable, but the right to transfer is restricted.
- ✓3. A private company is prohibited from inviting the public to subscribe to its shares or debentures, that is, it is not permitted to issue a prospectus

of the company nor is it allowed to advertise the sale of its shares.

4. ✓ A private company need not hold a Statutory Meeting nor is it required to circulate or file a Statutory Report.
5. ✓ A private company is not required to file with the Registrar of Joint-Stock Companies the following documents:—the consent of directors, the list of directors and the contract of directors.
6. ✓ A private company is not required to submit a Statement in lieu of Prospectus.
7. ✓ A private company has not to obtain from the Registrar a Certificate of Commencement of Business. It has not to secure the minimum subscription before allotment. It can, therefore, allot shares and commence business from the date of incorporation.
8. A private company need not circulate among its members the Balance-Sheet, the Profit and Loss Account or the Income and Expenditure Account or the Auditors' Report.
9. ✓ A private company need not have any director, though in actual practice it always has.
10. ✓ A private company need not observe the principle of the rotation of directors.
11. ✓ A private company must get its accounts audited but not necessarily by a registered auditor.
12. ✓ A private company must hold its annual general meetings and must place in the meeting the balance-sheet, the profit and loss account or



the income and expenditure account and the Auditor's Report.

13. ✓ A private company has to send a certificate, along with the "annual return", to the Registrar of Joint-Stock Companies that the number of shareholders is not more than fifty excluding the employee and ex-employee shareholders.
14. ✓ A private company cannot issue "share-warrants" to bearer.
15. ✓ In a private company there is no restriction in the appointment of managing agents and in the remuneration to be paid to them.
16. In a private company directors appointed by the managing agents may exceed one-third of the whole number of directors.
17. ✓ A private company can be organised without a share capital.

#### **Characteristics of Public Joint-Stock Companies:—**

1. ✓ The number of shareholders can never be less than seven. There is no maximum.
2. They have to file several documents with the Registrar of Joint-Stock Companies along with the memorandum of association and articles of association. These are:—the consent of the directors; the list of directors; the director's contract.
3. They have to issue a prospectus to the public or to file a Statement in lieu of Prospectus to the Registrar.

4. They must allot shares within 180 days from the date of the prospectus or from the date of the Statement in lieu of Prospectus.
5. They cannot allot shares till the minimum amount of shares, as required by the "articles", has been subscribed.
6. They cannot commence business just after the registration of the "memorandum" and the incorporation of the company. They have to fulfil certain formalities before a "certificate to commence business" is issued.
7. They have to hold a Statutory Meeting and to issue a Statutory Report to all the members and also to the Registrar within a certain period.
8. There must be at least three (two according to the old Act) directors, and at least two-thirds of them must be subject to rotation.
9. They can issue share-warrants to bearer provided the shares or stocks are fully paid.
10. There is no restriction on the transfer of shares.
11. They have to get their accounts audited every year by a registered auditor or auditors.
12. They have to send a copy of the balance-sheet and the profit and loss account or the income and expenditure account to all the members, and to hold an annual general meeting every year.
13. They have to file three copies of the balance-sheet and the profit and loss account with the Registrar.

14. They can appoint managing agents for twenty years at a time.
15. The remuneration to the managing agents should be a fixed percentage of the net profit of the company with a certain minimum in addition to office allowance. There is no maximum fixed.
16. They are not to give any loans to the managing agent.
17. The managing agent cannot have a right to nominate more than one-third the number of directors.

✓ **Difference between a Joint-Stock Company (public) and a Partnership:—**

1. A joint-stock company has an existence of its own, entirely separate from its members called "shareholders". It is a distinct, separate, legal entity. It can hold properties in its own name, and can sue or be sued in its own name. A partnership firm is not a legal person and has no separate existence as distinguished from the members composing it.
2. In the case of a partnership the property belongs to the individual partners, who are *collectively* entitled to it. In the case of a company the property belongs to the company itself, and not to its members. An incorporated company's assets are its own property, and not the property of the shareholders for the time being.
3. In a partnership the liability of the partners is unlimited, that is, each partner is liable for the

whole of the debts of the firm, whereas in a company the liability of each shareholder is limited to the amount unpaid on the shares held. No partner can reduce the liability of any other partner by agreement among themselves.

4. The creditors of a firm are creditors of all the individual partners. In a partnership creditors may also proceed against every partner individually besides proceeding against the partnership property. In a company creditors have no remedy beyond the property of the company. The company alone is the debtor.
5. Subject to any agreement every partner has an inherent right to take part in the management of the partnership and every partner is the agent of the firm and his other partners for purposes of the partnership business. A partner can incur debts and obligations within the scope of the partnership business to an unlimited extent, which bind the partnership and all the other partners. In the case of a company the business is generally managed by a board of directors, and the members have no right to take part in the management, neither are they agents of the company nor are their acts binding on the company.
6. In the case of an ordinary partnership any restrictions placed by the partners on the authority of any particular partner are of no avail against the outside world. In the case of a company all outside parties dealing with the company

are bound to read the memorandum and articles of association of the company and to acquaint themselves with all restrictions on the powers of the directors and other authorised agents of the company.

7. A partner cannot contract with the firm, but a member of a company can contract with the company. A sale by a person to a corporation of which he is a member is not, either in form or in substance, a sale by a person to himself. A sale by a member of a corporation to the corporation itself is in every sense a sale, valid in equity as well as in law.
8. Shares can be sold or transferred subject to such restrictions as may be imposed by the company's regulations, and the transferee of the shares will enjoy all the rights of membership of the company. In a partnership a partner cannot sell his share without the consent of all the partners. He can, however, assign his share, but the sole right of his assignee will be to receive the share of the profits to which the assigning partner could otherwise have been entitled.
9. In a partnership the number of partners is limited. In a company the number of shareholders is not so limited.
10. The objects of a company are governed by the memorandum of association which cannot be altered except with the consent of the court. A partnership, on the other hand, can modify its constitution as and when the partners choose to

do so, and is not subject to any statutory restrictions.

11. In a partnership the rights of members are regulated by the deed of partnership, and may be altered by mutual agreement. In a company the rights of its members, *i.e.*, the shareholders, are regulated by the articles which can be altered only by a resolution of the shareholders.
12. The capital of a company is fixed by its memorandum and articles of association and can only be increased or decreased in a special manner provided in the statutes. The capital of a firm may be increased by profits, decreased by losses, or altered by mutual agreement.
13. The law prescribes an annual audit for a company but none for a partnership.
14. Subject to any agreement between the partners, every partnership is dissolved by the death, or the bankruptcy of a partner; the combined existence of a company is not affected by the death or the bankruptcy of any shareholder, however large his holding may be.

**Registers to be Kept by a Company.**—Under the Act a limited company has to keep various registers:—

1. Register of Members. (Section 31.)
2. Index of Members. (Section 31A.)
3. Annual list of Members and Summary. (Section 32.)
4. Minute-books of proceedings of general meetings and of board meetings. (Section 83.)

5. Register of Directors, Managers and Managing Agents. (Section 87.)
6. Register of Contracts in which Directors are interested. (Section 91A.)
7. Register of Mortgages and Floating Charges. (Section 123.)
8. Proper books of account, of receipts and expenditure, sales and purchases and assets and liabilities. (Section 130.)

## **Section 7—Managing Agents and Management**

### **Appointment of Managing Agents:—**

In order to check the abuse caused by the interminable length of managing agency agreements, it is now provided by Section 87A that:—

(1) No managing agent can now, that is, from the commencement of the Amending Act of 1936, be appointed for more than 20 years at a time.

(2) Managing agents appointed before the commencement of this Act of 1936 shall be permitted to hold office for 20 years from the commencement of the above Act but not beyond that period unless reappointed for a further term; but the services of these managing agents (appointed before the commencement of 1936 Act) cannot be terminated even after 20 years until all moneys due to them for loans made to the company and for remuneration due to them by the company have been paid. Further, after the termination of office these managing agents shall be entitled to a charge upon the assets of the company, as indemnity for all liabilities and obligations properly incurred by them as managing agents on behalf of the company, subject to all existing charges and encumbrances, if any.

(3) This rule does not apply to a private company.

(4) Except in the case of a company's first managing agent appointed before the issue of the prospectus or the statement in lieu of prospectus in which the terms of the appointment of such a managing agent are set forth, the appointment or removal of a managing agent or variation of his contract after the 1936 Act shall not be valid unless



approved by the company by a resolution at a general meeting. (Section 87B.)

### **Removal of Managing Agents:—**

A company can remove a managing agent by a resolution at the general meeting of the company of which notice has been given to the managing agent in the same manner as to members of the company if he is convicted of a non-bailable offence, under the Penal Code, in relation to the affairs of the company. If the managing agent is a firm, or a company, such an offence committed by a member of such firm or by a director or an officer holding a general power of attorney, would be sufficient for purposes of this section. The managing agent, however, shall not be liable to be removed, if the offending member, director or officer as aforesaid is expelled or dismissed by the managing agent within 30 days of his conviction or if his conviction is set aside on appeal. (Section 87B.)

**Vacation of Office of Managing Agents.**—The office of a managing agent shall be vacated:—(1) if he is adjudged insolvent; or (2) if a company is wound up either by the court or voluntarily. In the last case, however, the right of the managing agent to recover any moneys from the company for premature termination of the agreement or otherwise, is not to be affected, except where the court finds that the winding-up was due to the negligence or default of the managing agent himself and then he shall not be entitled to compensation for premature termination of the contract. [Section 87B (b), (e).]

**Remuneration of Managing Agents.**—The basis of remuneration to the managing agents is not statutised. Formerly they were paid on one or more of several factors,

such as, (1) a percentage on the purchase of raw materials, or (2) on the sale of finished products, or (3) on profit, or (4) a fixed amount on each unit of production, etc. In addition to these they used to receive payments for various subsidiary services. The profits were also calculated not on a standardised method and often it was done to the advantage of managing agents. The Amending Act of 1936 has introduced far-reaching changes by Section 87C about the method of fixing the remuneration of the managing agent and how it should be calculated. This new rule, however, is applicable to managing agents who will be appointed after the commencement of the operation of the new Act, and does not affect agreements for remuneration of existing managing agents till their term expires which in many cases will terminate after 20 years, from the commencement of the new Act, and till then the old agreements will continue to be valid. The remuneration of managing agents shall be:—(1) a sum based on a fixed percentage of the net annual profits of the company, (ii) with a provision for a minimum, in case of insufficient or no profits, together with (iii) an office allowance to be defined in the agency agreement. Any additional remuneration shall not be binding on the company unless sanctioned by a special resolution of the company. By 'net profits' is meant the profits of the company calculated after allowing for (a) all the usual working charges, (b) interest on loans and advances, (c) repairs and outgoings, (d) depreciation, (e) bounties or subsidies received from Government or from a public body, (f) profits by way of premium or shares sold, (g) profits on sale of forfeited shares, and (h) profits from the sale of the whole or part of the undertaking of the company. No deduction shall, however, be made for (i) income-tax or super-tax, or any

other tax or duty on income or revenue; (ii) or for expenditure by way of interest or debentures or otherwise on capital account, (iii) or for any sum set aside for reserve or any other special fund.

This section does not apply to private companies or to insurance companies.

### **Restrictions on the Powers of Managing Agents:—**

1. No company shall make a loan to a managing agent, or to a partner of his firm, if the managing agent is a firm, or to any director of a private company, if the managing agent is a private company; nor should a company guarantee any such loan given to its managing agent. In the event of contravention of this rule every director of the company who is a party to the making of the loan or the giving of the guarantee shall be liable to a fine up to Rs. 500 and shall also be jointly and severally liable for the amount, if it is not paid.

There are two exceptions to this rule. It does not affect any credit held by the managing agent in the current account of the company for the company's business, provided the limits are previously approved by the board of directors. It also does not apply to private companies. It must also be noted that this restriction does not seem to apply if the managing agent is a public company.

2. A managing agent, or the firm of which he is a partner, or any partner of such a firm, or if a managing agent is a private company, a member or director thereof, shall not enter into any contract for the sale, purchase or supply of goods and materials with the company, except with the consent of three-fourths of the directors present and entitled to vote on the resolution. This provision does

not affect any such contract entered into before the commencement of the Amending Act of 1936. [Section 87D (5).] The practice with most of the managing agents was to sell or supply their own goods, machinery or material to the company, for its normal working. They charged commission even when they obtained the supplies from others. This section is an attempt to put a stop to such abuses of power.

3. No company should give a loan or guarantee a loan to another company when both are under the management of the same managing agent. This applies to companies incorporated after the commencement of the Amending Act of 1936, and also to existing companies six months after such commencement. Renewal of an existing loan will be permissible after the period of six months but not a fresh loan. This restriction does not affect a loan made or guarantee given by one company to another under its own management, or loans made by a company to its subsidiary or loans by a subsidiary to the holding company or to guarantees given by a company on behalf of its subsidiary. Any contravention will make the director or directors or officer responsible for the loan liable to a fine up to Rs. 1,000, and shall also be liable jointly and severally for the loan. (Section 87E.)

4. Except in the case of an investment company, that is, a company whose principal business is the acquisition and holding of shares, stocks, debentures or other securities, no company shall purchase shares and debentures of another company under the management of the same managing agent, unless the purchase has been previously approved by a unanimous decision of the board of directors of the purchasing company. (Section 87F.)

5. No managing agent shall exercise a power to issue debentures nor shall he have power except with the authority of the directors and within the limits fixed by them, to invest the funds of the company. Any such delegation of power by a company to the managing agent shall be void. (Section 87G.)

6. A managing agent shall not enter into any competing business with the business of the company or any subsidiary of such company. (Section 87H.)

7. The managing agent shall not appoint (if any) more than one-third of the total number of directors of a public company. (Section 87I.) It will be better still if the practice of appointing directors by managing agents or by anyone who will not be subject to retirement by rotation is put a stop to. According to Section 83B (2) these directors are not subject to retirement by rotation.

8. A managing agent cannot transfer or assign his office without the approval of the company at a general meeting. Any such measure shall be void. In this connection it is further provided that a change of partners in the managing agent's firm shall not be deemed a transfer for the purpose of this section, so long as one of the original partners continues to be a partner of the firm. "Original partners" mean, in the case of managing agents appointed before the commencement of the Amending Act of 1936, those who were partners at the date of the commencement of the said Act, and in the case of managing agents appointed after the commencement of the said Act, those who were partners at the date of the appointment. [Section 87B (e).]

9. A charge or assignment of his remuneration or any part thereof effected by a managing agent shall be void as against the company. [Section 87B (d).]

**Register of Managing Agents.**—A company is bound to keep a register of its managing agents in the same way as it is bound to keep in the case of directors and to enter similar particulars therein. (Section 87.)

✓ **Management.**—It has already been said that the directors of a company lay down the policy, appoint managers and other executive heads and supervise and control all the activities of the concern. The manager is the chief executive head and is responsible for carrying out the policy and the instructions of the board of directors in the day-to-day work. There are three methods of managing a company, *viz.*, (1) ✓ by an employee manager; (2) ✓ by a managing director or directors; and (3) ✓ by managing agents. In the first two of these it is said that the board of directors have full control over the manager and the management, whereas over managing agents the directors have practically no control.

In India there is a strong feeling against the managing agency system. The promoter appoints the managing agent, the person appointed is usually the promoter himself, or the firm of which he is a partner, or a company of which he is a director. Managing agents are appointed under a contract. The conditions of appointment are drawn up by the promoter himself and naturally they are always in his favour. The Companies Act has placed the control and management of a company in the hands of a board of directors and all the employees and agents appointed by the company are subordinate to them. But the terms of the agreement of managing agents are such that they make their position practically independent, and all in all, and the directors are reduced virtually to the position of nominal masters. Again, in the case of managers and managing directors the remunerations paid to them are for the work

they do and the services they render to the company, while it is said, that the managing agents receive remuneration though they do no work and are, therefore, an unnecessary burden on the company. These are the two reasons why people disapprove of the managing agency system and often say that this system plays a huge joke on the shareholders of a company. The basis of such a statement is that the directors, who have the power and control over the management of a company, are elected by the shareholders and they depend for their re-election on the satisfaction which they give to the shareholders by their honesty and efficiency. If the directors fail to give the desired satisfaction, the shareholders may elect others as directors. This is the reason why it is said that the ultimate and the real authority lies with the shareholders. But if the managing agents usurp all the powers of the directors and reduce them to the position of mere figure-heads, this automatically makes the powers of the shareholders ineffective. The task before us is to find out how far it is true that managing agents are paid very high remuneration though they do not work and render no service to the company; and also how far the shareholders are really deprived of their ultimate power to control the management of the company.

Managing agents are either individuals or partnership firms or joint-stock companies. They can be divided into three groups according to the nature of work they do, the power they wield and their efficiency and usefulness to the company they manage. There are managing agents who are managing agents in name only, there being little difference between them and the whole-time employee-managers. They work in the company in the same way as paid managers do and are guided and controlled in all their major activities

by the board of directors. The remuneration paid to them is for the service they perform as managers in their day-to-day work. It cannot be said of them that the company receives nothing in return for the payment made to them. Again, there are managing agents who are on the other extreme. They themselves do not work as managers or appoint others for this purpose. They simply supervise and control the work of the manager. The company pays for the manager and all other expenses in connection with the management, and in addition it pays the managing agents also. This payment to the managing agents, it is said, is for nothing because they render no service to the company and is, therefore, an unnecessary burden on it. It may be said that they supervise the work of the manager. But this work can very well be done by the directors who are meant for this purpose. The company then will not be burdened with an extra payment. In between these two extremes there are various gradations of managing agents with greater or lesser powers and freedom from interference of the board of directors.

Let us now analyse and find out how far the payment to the managing agents for their supervision work is unnecessary and, therefore, a burden on the company. In India there is a class of firms who specialise in managing other companies, some of them manage one or two dozen companies and are known as firms of managing agents. For this very purpose they engage a variety of experts to investigate into the prospects of different industries and in different parts of the country. As a result of their investigations they promote new companies and invest a large amount of their own capital in the new ventures and supervise and control the management of different companies as



managing agents. Being specialists in this line their supervision and control of different organisations under them is infinitely superior, more efficient and effective than what can ever be attained under the directors. It is true that for supervision and expert advice the managing agency firm receives an extra payment, but the advantage that accrues to the company thereby is certainly timely, more useful and above all worth more than the payment made by the company. Again, the managers who are employed by the managing agents for the different companies under their control are their employees. They are recruited while young and trained in different branches according to their aptitude, intelligence, education and ability; and after the training is over they are appointed first as junior officers in one of the managed companies and rise to higher posts as they prove their merit and in course of time the better, the more capable and efficient ones are put in charge of one of the companies. Of course it can be said that now there is no dearth of experienced and capable experts in India in almost all the existing industries and the board of directors can easily select one or more of them according to their need and thus save the extra payment made to the managing agents. But there is still one advantage left in their favour and it is their proper selection of industry or business and a suitable location. In India there is no institution to do this work for our promoters or organisers. Firms of the standing and reputation as, Birla Bros. Ltd., Tata Ltd., Martin & Co., etc, have got the necessary staff and resources, to select a proper industry and a suitable place for a new company and be sure of its success. Still another advantage is that all companies, particularly the manufacturing and trading concerns borrow a large portion of their working capital, and banks are willing to advance

loans only when the managing agent stands surety for the borrowing company. Of course, banks do not accept the surety of any and every managing agent. It must be a firm of a sound financial position. This clearly shows that the payment to the managing agent is not for nothing. Besides, there are other advantages which the company and therefore its shareholders derive from the managing agents who have specialised in this line and have adopted the promotion and management of companies as their chief business. But this cannot be said of all managing agents. There are many who have neither the resources nor the ability and efficiency of the better organised managing agents.

The next question is the extent to which power of directors and shareholders is really reduced by managing agents. There are no promoters in our country in the sense in which the term is used and understood in England and America. The promoter's special province is to find out and bring to the notice of investors new opportunities of making money: new natural resources to be exploited, new processes to be developed, new products to be manufactured, new organisations of existing business enterprises to be arranged, etc. But the promoter is seldom more than an explorer who points out the way for fresh advances of the army of industry. When an industry of his imagination has been organised and has begun to operate, the promoter does not often retain the leadership for long. As permanent officers, men of a more cautious temperament and more systematic habits commonly take command. In those countries the promoter's work is over after the new business is established and begins to function. The promoter has practically nothing to do with it afterwards. This is not so in India. We have no specialised promoters. Not only do our promoters conceive

the idea and organise and float a company and establish it, but they also continue their relationship with it by managing its affairs from year to year.

*J.S. Bhat.*

In the vast majority of cases, promoters in India are either the proprietors or partners of an existing business which is converted into a limited company, or firms of managing agents. The outgoing proprietors, their friends and relations, or the managing agents, as the case may be, purchase a large amount of shares of the company. The promoters and their relations, therefore, command enough votes to control the election of directors. Ordinarily, a little over 50 per cent of the total number of shares is necessary to control the election of directors. This high percentage of holding is necessary only when all the remaining shareholders are in one block. But this is never so, the remaining shareholders are never of one opinion. Further, there are methods of preventing other shareholders from combining and collecting enough votes in their hands. First, on the principle of investment it is never desirable for any one to invest a large portion of his capital in one company only. This automatically reduces the holdings of each shareholder and therefore the number of votes at his disposal. It is different with the former proprietors and promoters. They generally invest the whole of the capital which they had invested in their own firm in the shares of the new company which they themselves promote. Past success induces them, their friends and relations to buy a large number of the shares of the new company in the hope that the enlarged business will increase the profit further. Compared to any single shareholder, their stake being more, they naturally do not want that the management and control of the business should pass into some other hands. They would like to keep

it with themselves. For these reasons they purchase 30 to 50 per cent of the shares among themselves. It is possible to keep control over the management of a company with much less than 50 per cent of the shares. Anywhere between 10 to 25 per cent may be good enough to control votes and election.

We have already seen that to purchase a large number of shares in one company alone goes against the principle of investment. The investor distributes his investments and thus reduces his risks by purchasing shares in different companies and in different industries. This automatically increases the number of shareholders in a company, presuming that all the remaining shares are sold. If the holding is less it will decrease the desire, keenness and prospect of the individual shareholders to combine in order to capture the management. The holdings of each will be so small that it will be necessary to approach many shareholders before one can conceive the possibility of collecting enough votes. The task is uphill indeed and almost impossible of success. The promoter, in his own interest, can make the task of the other shareholders still more difficult by adopting methods given below.

The proposed directors are the nominees of the promoter and the allotment of shares is in their hands. If a large number of shares has been applied for, the directors can pick and choose the shareholders. They should allot shares to as many applicants as is possible and to each a few shares only. Again, when allotting shares they should bear in mind that the majority of persons selected should not be from the same place or from within a limited area, they should be scattered far and wide. If shareholders are many and are distributed over a wide area, they will not know one another, it will be

expensive for them to go about and make alliances with shareholders at distant places, hence it will practically be impossible for any such group of shareholders to gather together even 5 or 10 per cent of votes. In the circumstances it may be possible for the promoter, his friends and relations to keep the management and control of the company in their hands by purchasing and holding about 15 p.c. of the shares in their names. If what has been said is true, it follows that shareholders holding shares to the extent of 85 per cent of the total share capital of a company have no voice in the election of directors. It is, therefore, a myth that the ultimate control of a company is in the hands of its shareholders, for shareholders as such have no power. It is only a handful of them who by holding only 15 to 20 per cent of the total capital of a company can maintain the control of the company in their hands.

*J.B. Bishr*      *J.B. Bishr*

The majority of shareholders do not care how the company is managed, so long as it remains financially sound and the dividend is adequate. To them it is immaterial what the form of management is because the truth is that in every case the real power always lies with the promoter. If he has to appoint himself or his nominee or his firm as the chief executive officer of the company, and has to manage the whole show himself in one capacity or the other, what difference does it make whether he calls himself a manager, a managing director or a managing agent? The real factors are the efficiency, the ability and, above all, the organisation that the promoter can bring to bear upon his task because the success or profits of a company depend upon these. If the promoter is a reputable firm of managing agents, he will bring with him experience, ability, resources and a vast organisation and will manage the company as its managing

agent. His organisation is such that he cannot do it in any other capacity, whereas, if the promoter is the proprietor or partner of an outgoing concern, he may do it either as a managing director or a managing agent. Such a person may have efficiency and ability but certainly not the organisation.

In the early days of the joint-stock company organisation in England, individual proprietors or partners converted their firms into incorporated companies and invested a large amount of their capital in the shares of the companies which they promoted. In those days experienced and capable men were not available to manage joint-stock companies. The outgoing proprietor or the partner had sufficient experience, ability, resources and stake in the prospects of the new company and was appointed a director and also manager, and was designated a managing director. It was not practically feasible for the board of directors to manage the business in its day-to-day activities, nor were they competent to do it. They, therefore, appointed one of them, the outgoing proprietor or the partner, who had the requisite qualification, experience, and also a stake in the business being a large shareholder, as the manager on behalf of the directors and he was called a managing director. The appointment of managing directors is *invariably* incorporated in the articles of association of the company.

At the present time proprietary firms are not usually converted into companies. Many of them are promoted directly. Times have changed; experienced and capable men are now available and one of them is appointed the managing director of the company and he also invests a large amount of capital in the shares of the company. He is a

whole-time employee. From the point of view of efficiency there is no difference between a managing director and a manager—provided both are equally capable. The managing director, however, is more responsible being also a director and a large shareholder. The board can delegate some of its powers to him because he is also a director, but this the board cannot do to the manager. This often increases efficiency and expedites business. In India the managing directorship is not of the same type as it is in England, though late Sir Sorabji Nusserwanji Puchkhanwala of the Central Bank of India was a managing director of the British type. Not many companies in India are managed by managing directors and the very nature of their organisation is such that they lack efficiency. They are not usually whole-time managers and often two persons are appointed managing directors in a company. They have also their own business to attend to and over and above that they take the responsibility of supervising and managing the company on behalf of the board of directors. In such organisations they must have one assistant manager on the spot to carry on the work from day to day because the managing director does not stay at the place of work, he comes there for a few days in a week or fortnight and on other days the assistant does the work. The principle on which two men are now appointed managing directors is that when one of them is absent, the other will be present and the business will have someone responsible to supervise the work all the time. But it must be noted that such managing directors cannot give their whole attention to the business because they have other business to attend to, and they usually do not have the requisite experience and expert knowledge; consequently, the management is less efficient and not so effective. It is also

more expensive as will be clear from the following illustration:—

1. Each managing agent is paid Rs. 250 and in some cases Rs. 500 per month as honorarium, in addition to, say, Rs. 200 paid to the assistant manager.

2. The managing directors are also paid travelling expenses almost every week to go to the place of work from their headquarters and a free and furnished quarter has to be maintained for them which costs at least Rs. 300 per month. The total comes to Rs. 1,000 to Rs. 1,500, the exact amount depending upon the honorarium.

3. No management can be efficient where there are two masters for no amount of watertight division of work between the two can prevent conflicting orders and the consequent bad effect on the business.

The company has to spend one thousand to fifteen hundred rupees per month, yet it cannot get the services of an expert. Within this amount a really clever man can be appointed and under him the business is bound to prosper.

There are managing agents who have no organisation of their own, no staff to investigate the prospects of the company they promote, no resources or sufficient capital of their own to invest in the shares of the new company, neither the efficiency nor the training to manage a business; consequently, they do not do well and often fail and are, therefore, of no service to the investors and to the country. There is nothing to choose between this type of managing agents and the managing directors discussed above; both are equally incapable and inefficient. As a matter of fact, they bring discredit to Indian managed concerns, good, bad and indifferent alike; and the result is that people, as a rule, entertain doubts about the success of even good, sound and



well-managed concerns. They not only are inefficient but also often so manipulate as to enrich themselves at the cost of the unwary shareholders. They have brought discredit to the whole system and the unfortunate investors who have suffered heavy losses at the hands of such unscrupulous firms, in their resentment, fail to discriminate between the good and the bad, and condemn all of them alike. The feeling was so strong that a section was definitely in favour of abolishing the managing agency system altogether by legislation when the bill for the Indian Companies (Amendment) Act, 1936, was being discussed in the Assembly. In their enthusiasm to condemn the system they put forward reasons which were not very sound though they easily caught the imagination of laymen. An instance of such argument is that the directors have no control over managing agents, consequently the shareholders have no control over the company. I have given above convincing reasons that a vast majority of shareholders never had and shall never have any real control over the management of a company. This is true of companies in every country and, more so, in our country because the scheme of the promoters here who organise a company seek to manage it and to keep the control of the company in their own hands, and this they can do only by purchasing and holding a controlling amount of shares of the company. It has also been explained that for all practical purposes there is really no difference between the control of a company by the directors and by its managing agents, for example, Martin & Co., is the managing agent of the United Provinces Electric Supply Co. Ltd. What difference does it make, in its practical bearing, whether the supply company is managed by Martin & Co. or by its directors? In either case the chief persons are the same,

because the chief directors of the supply company are the two chief partners of Martin and Co. Finally, shareholders do not care much if the remuneration paid to a managing agent is high provided the net profits of the company is adequate enough, and there has not been any foul and underhand practice to deprive the company or its shareholders of their profits.

This does not mean that there are no defects or undesirable practices among the more reliable firms of managing agents. In fact some of these have become common in the system; such as, the practice of charging commission on purchases made for the company, on the sale of shares, and charges on the amount of production and on the amount of sale of finished products etc. The Amending Act of 1936 has introduced restrictive rules and regulations to stop the evil and the bad practices which have become a part of the system. The clever among the managing agents will always find out methods and devise to escape the clutches of law to perpetuate some of the evil practices to increase their income, yet there is no doubt that the bad practices will be considerably reduced.

In conclusion it can be said, that so long as we do not have in our country a specialised institution of the type of investment banking companies to investigate the prospects of different industries and at different places, the services rendered at present by large and well-organised firms of managing agents are absolutely necessary for the industrial development of our country. We should not condemn them on the ground that they make huge profits from this business, we should learn to appreciate their merit and the services they perform to the vast investing public in particular and to the industrial development of the country in general. The

very fact that they sell easily shares of the companies they float is a proof that there is a demand for the services of such firms and that they are on the whole useful to individual investors and to the country. It is fortunate indeed that good sense prevailed and the Assembly did not abolish the managing agency system and decided to pass stringent and restrictive rules and regulations only to prevent undesirable practices to continue. As people were so bitterly critical about the managing agency system, what one fails to understand is their silence about the managing directors, a form of management which is the least efficient and has, besides, all the defects of the former. The silence may be due to the fact that the number of managing directors is comparatively few, or it may be possible that the difference between the British type of managing directorship and ours is not clearly grasped. Managing directors should be whole-time men and there should be only one managing director in a company, at least one person should be in charge of the whole business. This will increase the efficiency and improve the management. The managing directorship of the Indian brand, viz., only part-time managers, should be abolished altogether either by convention or, if necessary, by legislation, and the sooner it is done the better. The managing directorship of the British or the American<sup>1</sup> type with a whole-time man, selected for his efficiency and ability, and also because of his stake in the business as the chief executive officer of the company, will certainly be very desirable and more useful.

**The Managing Agents and the Financing of Industries.**—By financing is meant supplying capital to a

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<sup>1</sup> In America he is called 'President.'

company which it obtains by selling its shares to the public or by borrowing. In the absence of investment banking institutions (to be discussed in a later chapter) and professional promoters, managing agents not only organise and promote a new company but also finance it in several ways as given below :—

1. We have already seen that a managing agency firm organises a company with a view to run it and to manage it. This it can do only by purchasing a controlling amount of shares of the company. A managing agent, therefore, invests a large amount of its capital in the shares of the company it promotes.
2. Friends and relations of the managing agent who know thoroughly well about his ability, efficiency and honesty, easily purchase shares of the company, which they would not do if it were not for the managing agent.
3. If a firm of managing agents has already established a reputation for sound judgment in promoting companies and in efficient management, the public will purchase shares of such companies willingly and in large numbers; but the company alone shall never be able to sell so many shares without the help of the managing agents.
4. Every company has to borrow a major portion of the working capital it requires from banks. Banks in India have established a practice of lending to a company on the surety of its managing agent provided that the financial

position of the latter is sound enough. Cases are known where banks have refused to lend to companies because the financial position of the managing agents was not good enough to warrant loans. This shows the importance of well-organised, efficient and financially sound firms of managing agents in the financing of industries.

5. There is one peculiarity in Ahmedabad and Bombay where people deposit money in the textile companies in the same way as they do in banks, because of the high reputation and very sound financial position of the managing agents in those towns. The companies benefit because they obtain their working capital, and sometimes fixed capital also, at a considerably lower rate of interest compared to what they have to pay to banks and to others.

## Section 8—Winding-up

**Winding-up.**—Section 155 gives three methods of winding-up: (i) winding-up by the court, which is also called compulsory winding; (ii) voluntary winding-up; and (iii) winding-up subject to the supervision of the court. Section 207 of the Amending Act of 1936, has divided voluntary winding-up into two classes, namely, “members’ voluntary winding-up” of solvent companies and “creditors’ voluntary winding-up” of insolvent companies.

**Winding-up by the Court.**—A petition to the court for the compulsory winding-up of a company can be made either by the company, or by any creditor or creditors, or by a contributory, or contributories, or by all or any of these parties, together or separately, or by the Registrar on any one of the following grounds:—

1. If the company has passed a special resolution that the company be wound up by the court.
2. If default is made in filing the statutory report or in holding the statutory meeting. It is not applicable to a private company. The court may, if it pleases, condone such a default and allow further time to the company to complete the things which it had omitted to do.
3. If the company does not commence its business within a year from its incorporation, or suspends its business for a continuous period of

one year or more. In this case also the court has discretion to condone the default for some satisfactory reason.

4. If the number of members is reduced, in the case of a private company, below two or, in the case of any other company, below seven.
5. If the company is unable to pay its debts. Whether a company is or is not able to pay its debts can be ascertained only by going through its accounts. The applicant can, if he chooses, prove from the accounts that the company is unable to pay its debts. But it is not so easy to do it, particularly because the applicant cannot get the necessary facilities to prove it. In addition to this, the company law recognises two circumstances, either of which is regarded as sufficient proof that the company is unable to pay its debts. These are:—
  - (a) If a creditor who has to receive more than Rs. 500 from the company, serves a notice of demand at the registered office of the company and the company fails to pay him within three weeks from the date of the receipt of such a notice, or fails to arrive at an arrangement to the satisfaction of the creditor.
  - (b) If a decree-holder against the company executes his decree and the execution officer returns the execution-warrant to the court as remaining wholly or partly

unsatisfied in spite of efforts made to realise the amount (Section 163.)

6. If the court is of opinion, upon the facts brought to its notice, that it is just and equitable that the company should be wound up. Examples:—(1) If the whole subject or purpose of the company appears to be fraudulent or illegal. (2) If the court is satisfied that the company cannot carry on its business except at a loss.

**Liability as Contributories.**—In the event of a company being wound up, every member, present and past, becomes responsible according to Section 156, to contribute to or pay to the assets of the company provided they are not enough to meet the liabilities and expenses of winding-up. A contributory is, thus, a person who is liable to contribute to the assets of the company in case the company goes into liquidation. (Section 158.) Shareholders who have not fully paid up their shares are contributories. Debtors of the company on business transactions with it are not contributories. A past member shall be liable to pay only if he has ceased to be a member within one year before the commencement of winding-up, in respect of any debt or liability contracted during his membership and the present members are unable to meet the liabilities; but no member, past or present, shall be required to pay in the case of a company limited by shares more than the amount unpaid on shares in respect of which he is liable.

When the court gives an order for the winding-up of a company, it appoints a liquidator. He prepares two lists of contributories, list A and list B. In list A are entered



the names of the present shareholders whose shares are not fully paid up. In list B are given the names of those persons who have been the holders of these shares within the last one year.

The money due on any shares will be realised as far as can be done from the contributories entered in list A. If the money so realised together with the other assets of the company is sufficient to meet the debts and liabilities of the company, then no further demand can be made from the contributories in list B. If, however, the debts have not been fully paid off, then demand will be made in respect of any share which has not yet been fully paid up from persons entered in list B in respect of those shares. (Section 156.)

The liquidator (or liquidators) appointed by the court must take into his possession, or under his control, all the property, effects and actionable claims to which the company is or appears to be entitled. All the property and effects of the company shall be deemed to be in the custody of the court as from the date of the order for the winding-up of the company. (Section 178.)

#### **Statement of Affairs to be made to the Liquidators.**

Within 21 days from the date of the appointment of the liquidator or within such extended time as the liquidator or the court may permit, the secretary or the manager of the company must submit a statement to the liquidator. The statement should be verified by the directors and should contain the following particulars:—

- (a) the assets of the company, stating separately the cash balance in hand and at the bank;
- (b) the debts and liabilities;

- (c) particulars of unsecured creditors, and of secured creditors with particulars of securities; and
- (d) particulars of book debts due to the company and of debtors, together with an estimate of the amount likely to be realised therefrom.  
(Section 177A.)

Within a month from the date of the order for the winding-up of the company the official liquidator should convene a meeting of the creditors to determine the desirability of appointing a committee of inspection to act with the liquidator and it shall have the right to inspect the accounts of the official liquidator at all reasonable times. Following the English Act of 1929, this new feature has been introduced in the winding-up by the court and in the creditors' voluntary winding-up. (Sections 178A and 209C.)

**Statement by Liquidator.**—The official liquidator has also to submit a report to the court within four months or as soon as practicable after the date of the winding-up order about the financial position of the company and the causes of its failure. He is also to report to the court if he suspects any fraud by any director or directors, promoters, officers, etc., of the company. (Section 177B.)

If in the course of a compulsory winding-up it is brought to the notice of the court, by the official liquidator or by any other person, that there are suspicious circumstances requiring thorough investigation, or that material evidence is being withheld from the official liquidator, or it appears that fraud or dishonesty has been committed by an officeholder of the company the particulars whereof are being concealed, then the court may order that any director,

manager, secretary, auditor or other office-bearer of the company, or any debtor of the company, or any person in possession of any property belonging to the company, or any person likely to be able to give information on any matter relating to the working of the company in the past, be called and examined publicly, *i.e.*, in the presence of a member of the public who may care to attend and who may make suggestions to the court, about any question that may be put to the person under such public examination. (Section 196.)

**General Meeting of Creditors or Contributories.—**

The official liquidator may summon general meetings of the creditors or contributories for the purpose of ascertaining their wishes, and it shall be his duty to summon meetings at such times as the creditors or contributories, by resolution, may direct, or whenever requested in writing to do so by one-tenth in value of the creditors or contributories, as the case may be. (Section 183.)

**Maintaining of Accounts and Other Books by the**

**Liquidator.**—The official liquidator must maintain proper minute-books and other books as may be prescribed by the court, and shall present to the court, not less than twice in each year, an account of his receipts and payments. The court shall cause the account to be audited, and one copy of the audited account shall be filed and kept by the court, and the other copy shall be filed with the Registrar, and each copy shall be open to inspection by any creditor or other interested persons. (Section 182.) Auditing of the liquidator's account is a new provision. .

**Court's Power to Order Payment of Cost for Winding-up.**—If the assets of the company under liquidation are not sufficient to meet the liabilities, the court may

pass an order for payment, out of the assets, of the costs, charges and expenses incurred in the winding-up in such order of priority as the court thinks just. (Section 193.)

**Order of Payment in Winding-up.**—1. Secured debts, *i.e.*, debts for which a fixed charge or mortgage has been created, stand in a separate class of their own. The mortgagee must not take any steps upon a winding-up, unless he himself chooses to do so; for even if the mortgaged property is sold by the liquidator the mortgagee's right to realise his money by sale of that property will not be affected by reason of the fact that the property has been sold to some other person. But the mortgagee may choose to come up to the liquidator to prove his debts, and this he will generally do in case he feels that the present value of the mortgaged property will not be sufficient for the full payment of his debt. In such a case he has the option of either relinquishing his mortgage and getting himself entered as an unsecured creditor or of putting a value to the mortgaged property and getting himself entered as an unsecured creditor for the balance.

2. All costs, charges and expenses properly incurred in the winding-up, including the remuneration of the liquidator shall, subject to the rights of secured creditors, if any, be payable out of the assets of the company in priority to all other claims. (Section 217.)

3. Then come certain payments which are called preferential payments. (Section 230.) These payments are on account of the following:—

- (a) land revenue, taxes, cesses and rates, payable to the Government or to a local body, such as the Municipality or the District Board, due from the company which became payable at

any time within twelve months from the date of the commencement of winding-up, that is, from the date of the order of the court in case of compulsory winding-up, and from the date of the resolution, in case of voluntary winding-up. [Section 230 (5) (a) (b).]

- (b) all wages or salary of any clerk or servant in respect of service rendered to the company for two months immediately before the date of the commencement of winding-up, subject to a maximum of one thousand rupees for each clerk or servant;
- (c) wages of labourers or workmen due to them from the company within two months from the commencement of the winding-up, not exceeding five hundred rupees for each man;
- (d) compensation payable under the Workmen's Compensation Act, 1923, in respect of the death or disablement of any officer or employee of the company;
- (e) all sums due to any employee from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the employees maintained by the company;
- (f) a landlord who has attached any goods of the company within the preceding three months for arrears of rent due to him.

The foregoing debts (called preferential payments) shall rank equally among themselves and be paid in full,

unless the assets are insufficient to meet them, in which case they shall be paid in equal proportion.

4. Then come the debenture-holders whose floating charge has become fixed either by reason of the fact that they appointed a receiver according to the conditions of the debenture or by the fact that the company has gone into liquidation.

5. Then come the unsecured creditors who are paid *pari passu*, i.e., irrespective of the dates when they became creditors.

6. The balance left over after all the above payments is distributed among the shareholders in accordance with their respective rights.

**Dissolution of the Company.**—When the affairs of the company have been completely wound up, the court shall issue an order that the company be dissolved from the date of the order, and the company shall be dissolved accordingly. The official liquidator must inform the Registrar of the dissolution of the company within fifteen days from the date of the order and the Registrar must record it in his books. (Section 194.)

#### VOLUNTARY WINDING-UP.

A company can go into voluntary liquidation on any ground after passing an appropriate resolution as given below:—

1. When the period (if any) fixed for the duration of the company by the articles expires, or

the event (if any) occurs, on the occurrence of which the articles provide that the company is to be dissolved and the company in general meeting has passed a resolution requiring the company to be wound up voluntarily.

2. If the company resolves by special resolution that the company be wound up voluntarily.
3. If the company resolves by extraordinary resolution to the effect that it cannot by reason of its liabilities continue its business, and that it is advisable to wind it up.

A voluntary winding-up shall be deemed to commence at the time of the passing of the resolution for voluntary winding-up. (Section 204.)

Notice of any special resolution or extraordinary resolution for winding-up a company voluntarily must be given by the company within ten days of the passing of the resolution in the local official gazette, and also in some local newspaper, if any, where the registered office of the company is situated. (Section 206.)

Section 207 of the Amending Act of 1936, has divided voluntary winding-up into two classes, namely, "~~members'~~ voluntary winding-up" of solvent companies and "creditors' voluntary winding-up" of insolvent companies. If the directors of a company or a majority of them make a declaration, verified by an affidavit, to the effect that they have made a full inquiry into the affairs of the company, and that, having done so, they have formed the opinion that the company shall be able to pay its debts in full within a period not exceeding three years from the commencement of

the winding-up, and if such declaration is supported by a report of the company's auditors on the company's affairs, and if it is delivered to the Registrar for registration, before the day on which the notices of the meeting at which the resolution for the winding-up of the company is to be proposed are sent out, a voluntary winding-up resolved upon in accordance with the provisions of Section 203 is referred to in the Act as a members' voluntary winding-up. A winding-up in the case of which a declaration has not been made and delivered as aforesaid is referred to as a creditors' voluntary winding-up.

**Appointment of Liquidators.**—The company at a general meeting shall appoint one or more liquidators for the purpose of winding-up the affairs and distributing the assets of the company, and may fix the remuneration to be paid to him or them. On the appointment of a liquidator all the powers of the directors shall cease, except so far as the company in general meeting, or the liquidator, sanctions the continuance thereof. (Section 208A.)

**Liquidator to Call a General Meeting.**—In the event of the winding-up continuing for more than one year, the liquidator shall summon a general meeting of the company at the end of the first year from the commencement of the winding-up and of each succeeding year, or as soon thereafter as may be convenient within ninety days of the close of the year, and shall lay before the meeting an account of his acts and dealings and of the conduct of the winding-up during the preceding year and a statement in the prescribed form containing the prescribed particulars with respect to the position of the liquidation. (Section 208D.)

**Final Meeting and Dissolution.**—As soon as the affairs of the company are fully wound up, the liquidator



shall make up an account of the winding-up, showing how the winding-up has been conducted and the property of the company has been disposed of, and thereupon shall call by advertisement a general meeting of the company for the purpose of laying before it the account, and giving any explanation thereof.

Within one week after the meeting, the liquidator shall send to the Registrar a copy of the account, and shall make a return to him of the holding of the meeting and of its date, and if for want of a quorum the meeting could not be held, the liquidator shall, in lieu of the said return, make a return that the meeting was duly summoned and that no quorum was present thereat, and upon such a return being made, the provisions as to the meeting of the return shall be deemed to have been complied with. The Registrar on receiving the account and either of the returns mentioned above shall forthwith register them and on the expiration of three months from the registration of the return the company shall be deemed to be dissolved. (Section 208E.)

#### CREDITORS' VOLUNTARY WINDING-UP.

**Convening of Creditors' Meeting.**—Section 209A lays down the procedure for convening a meeting of the creditors. The creditors' meeting is to be held on the day, or on the day following that day, on which the meeting of the company is held to decide about the voluntary winding-up. The notice to the creditors should be sent by post, it should be advertised in the local official gazette and also in

some newspaper circulating in the district where the registered office of the company is situated.

The directors of the company should place before the creditors' meeting a full statement of the company's affairs together with a list of creditors and the estimated amount of their claims, and appoint one of themselves to preside at the said meeting.

**Appointment of Liquidator.**—The creditors and the company at their respective meetings may nominate a person to be a liquidator for the purpose of winding-up the affairs and distributing the assets of the company, and if the creditors and the company nominate different persons, the person nominated by the creditors shall be liquidator, and if no person is nominated by the creditors the person, if any, nominated by the company shall be liquidator. (Section 209B.)

**Committee of Inspection.**—The creditors at the meeting or at any subsequent meeting may appoint a committee of inspection of not more than five persons, and if such a committee is appointed, the company also may appoint an equal number to act as members of the committee. The creditors can object to all or any of the persons appointed by the company to be members of the committee of inspection, and, if the creditors so resolve the persons mentioned in the resolution shall not be qualified to act as members of the committee unless the court decides otherwise. The court, on receiving an application, may appoint other persons to act as such members in place of the persons mentioned in the resolution.

**Liquidators' Remuneration.**—The committee of inspection, or if there is no such committee, the creditors, may fix the remuneration to be paid to the

liquidator or liquidators, and where the remuneration is not so fixed, it shall be determined by the court. (Section 209D (1).]

**Directors' Powers.**—On the appointment of a liquidator, all the powers of the directors shall cease, except so far as the committee of inspection, or if there is no such committee, the creditors, sanction the continuance thereof [Section 209D (2).]

**General Meeting and Dissolution.**—The procedure for holding annual general meetings and the final meeting for the dissolution of the company is prescribed by Sections 209G and 209H. It is the same as in the case of members' voluntary winding-up, with this difference that in the case of creditors' voluntary winding-up (1) creditors' meetings are to be called by the liquidator in addition to the meetings of the shareholders, (2) and no time-limit is fixed for the holding of the general meeting.

When a company goes into voluntary liquidation the general policy of the law is to allow the thing to be done without the intervention of the court. But if there is a dispute between the liquidator and any other interested person, then either party can refer the dispute to the court and the court will decide it. Or any creditor or contributory or the liquidator can apply to the court that things are not being done properly, that partiality or dishonesty or suppression of facts is going on, or that the directors or the managers are putting obstacles in the way of the liquidator's finding out all things relating to the company and ask the court either to take the liquidation under the supervision of the court or to convert it into a compulsory winding-up by the court, and the court may, thereupon, if it thinks fit, adopt one or the other of these two courses.

*Notes.*—For convenience of reference, the Scale of Fees for registration of a company is shown below:—

I. For a company having a share capital.

Authorised Capital Rs.	Fees Rs.	Authorised Capital Rs.	Fees Rs.
20,000	40	9,00,000	525
30,000	60	9 50,000	550
40,000	80	10,00,000	575
50,000	100		
60,000	105	11,00,000	585
70,000	110	12,00,000	595
80,000	115	13,00,000	605
90,000	120	14,00,000	615
1,00,000	125	15,00,000	625
1,50,000	150	16,00,000	635
2,00,000	175	17,00,000	645
2,50,000	200	18,00,000	655
3,00,000	225	19,00,000	665
3,50,000	250	20,00,000	675
4,00,000	275	21,00,000	685
4,50,000	300	22,00,000	695
5,00,000	325	23,00,000	705
5,50,000	350	24,00,000	715
6,00,000	375	25,00,000	725
6,50,000	400	26,00,000	735
7,00,000	425	27,00,000	745
7,50,000	450	28,00,000	755
8,00,000	475	29,00,000	765
8,50,000	500	30,00,000	775

Authorised Capital Rs.	Fees Rs.	Authorised Capital Rs.	Fees Rs.
31,00,000	785	44,00,000	915
32,00,000	795	45,00,000	925
33,00,000	805		
34,00,000	815	46,00,000	935
35,00,000	825	47,00,000	945
		48,00,000	955
36,00,000	835	49,00,000	965
37,00,000	845	50,00,000	975
38,00,000	855		
39,00,000	865	51,00,000	985
40,00,000	875	52,00,000	995
		52,50,000 & 1,000	
41,00,000	885	upwards	
42,00,000	895		
43,00,000	905		

For an increase of authorised capital, the fee payable as shown above on the authorised capital as increased less the fee already paid is to be paid to the Registrar.

If authorised capital is reduced and subsequently increased, no fee is in practice charged if the authorised capital as increased does not exceed the authorised capital before reduction, and the difference of fees is charged on the excess of the authorised capital as increased over the authorised capital before reduction.

*Illustration.*

- (1) Authorised Capital increased from Rs. 16,00,000 to Rs. 40,00,000.

	Rs.
Fee on Rs. 40,00,000	... 875
Less Fee paid on Rs. 16,00,000	... 635

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Balance of Fees now payable on the increase 240

(2) Authorised Capital reduced from Rs. 16,00,000 to Rs. 14,00,000.

(a) Subsequently increased to Rs. 16,00,000: No Fee is payable.

(b) But if increased to Rs. 40,00,000: Rs. 240 is payable.

(Fee is payable on the increase of Rs. 24,00,000 and not on the increase of Rs. 26,00,000).

## II. For a company not having a share capital.

Number of members as stated in the articles of association.	Fees Rs.	Number of members as stated in the articles of association.	Fees Rs.
20	40	950	185
100	100	1,000	190
150	105	1,050	195
200	110	1,100	200
250	115	1,150	205
300	120	1,200	210
350	125	1,250	215
400	130	1,300	220
450	135	1,350	225
500	140	1,400	230
550	145	1,450	235
600	150	1,500	240
650	155	1,550	245
700	160	1,600	250
750	165	1,650	255
800	170	1,700	260
850	175	1,750	265
900	180	1,800	270

Number of members as stated in the articles of association.	Fees Rs.	Number of members as stated in the articles of association.	Fees Rs.
1,850	275	2,550	345
1,900	280	2,600	350
		2,650	355
1,950	285	2,700	360
2,000	290	2,750	365
2,050	295	2,800	370
2,100	300		
2,150	305	2,850	375
2,200	310	2,900	380
		2,950	385
2,250	315	3,000	390
2,300	320	3,050	395
2,350	325	3,100 or up-	400
2,400	330	wards.	
2,450	335	Unlimited	400
2,500	340		

For an increase of the number of members, the fee payable as shown above on the total number of members as increased less the fee already paid is to be paid to the Registrar.

*Illustration.*

Number of members increased from 2,350 to 3,000—

	Rs.
Fee on 3,000 members	... 390
Less Fee paid on 2,350 members	... 325
	—
Fee payable on the increase	... 65
	—

III. For an Association not for Profit (S. 26)  
A fixed Fee of Rs. 50 is payable.

This may be compared with—

- (i) The fee of Rs. 50 payable for the registration of a Society under the Societies Registration Act, 1860 (No. XXI of 1860); and
- (ii) The fee of Rs. 100 payable for the registration under the Provident Insurance Societies Act, 1912 (No. V of 1912) of a Provident Insurance Society (other than a society incorporated under the Indian Companies Act).

IV. For companies established outside British India. (Section 277.)

A Fee of Rs. 5 is payable for filing each document. Initially four such documents have to be filed and a fee of Rs. 20 is payable.

#### V. Exemptions.

No fee is payable for filing (i) the memorandum of association, (ii) the abstract required to be filed with the Registrar by a receiver (S. 119), and (iii) the statement required to be filed with the Registrar by the liquidator in a winding-up (S. 244).

All fees under the Indian Companies Act, 1913, are payable to the Registrar in cash.



## CHAPTER V

### COMBINATIONS.

**Classes of Combination Organisation.**—Two or more persons may combine together to form a partnership or a joint-stock company. Such a combination is called a “simple combination.” There are also combinations in which two or more business units may combine together either to form one business unit or each of the combining units may remain separate and independent, and yet they may combine together for some common object or advantage. This is called a “compound combination.” For example, two or more partnerships, or two or more companies, or both partnerships and companies, each of which is a combination in itself, may again combine together to form a business unit or for any object common to them all. In such a case it will be a combination of combinations. It is true that a compound combination is not necessarily always so. For instance, two or more individual proprietorships may combine together; still the combination will be a compound combination though an individual proprietorship itself is not a combination. At the present time combinations are mostly among companies or partnerships or both companies and partnerships; hence we can safely say that compound combinations are combinations of combinations. The essential difference between the two is that a simple combination is a combination of individual persons, while a compound combination is a combination of business units. ]

There is only one kind of simple combination, viz., "association," and the highest and the most efficient form of organisation by simple association is a corporation or a joint-stock company. There are several types of compound combination, ranging from a simple form of association or agreement to the most complete form of union, viz., fusion.

The simplest form of compound combination is one in which several business units in the same locality or within a geographical area combine together to form an "association" for common benefit. Trade associations, chambers of commerce, and agreements are examples of the association form of combination. Business men in a town may suffer from inconveniences of octroi, unhealthy conditions in market-places, bad roads, high railway freights, terminal difficulties, etc. From experience they know that individual efforts to remedy these difficulties are usually of no avail and the only means of removing them is to combine together for joint effort. The wholesale and retail traders in a town engaged in the same or different trades, suffering from the same difficulties or inconveniences, may join together to form a trade association to determine ways and means to remove or overcome them. A chamber of commerce is a similar association of manufacturers and traders; but its area of operations is usually wider than a town and in India it is usually a province or a part of a province. Sometimes it is formed on communal lines such as, a Marwari Chamber of Commerce, a Maharashtra Chamber of Commerce, a Muslim Chamber of Commerce, etc. In principle the purpose of both is the same, viz. (1) to remove difficulties and (2) to increase facilities, though the scope of a chamber of commerce is wider and more comprehensive than that of a trade association. (a) It represents to the pro-

Advantages

## COMBINATIONS

vincial and central governments the views and requirements of its members and the special needs of particular industries regarding tariffs and other facilities. Besides this, it also tries to be useful to its members, and through them, to the business community in general by collecting information and necessary data about different industries and other business requirements. The term 'combination' when used alone, usually means a compound combination, that is, a combination of associations or of business units.

Often business units combine for a closer or more intimate co-operation. The organisation and management of a business can be divided into two distinct parts, viz., (1) external (2) internal. The determination of the amount to be produced by a business from day to day, or the determination of markets where its finished products are to be sold are matters external, while the employment of experts and other employees, the amount of salary or remuneration to be paid to them, the amount of work each should be required or expected to perform, the extent and nature of supervision, etc., are matters which concern the internal organisation and management of a company. These two aspects of organisation and management are found not only in business but also in the organisation of the government of a country.

The various independent states or provinces of a country may unite together to form a central government, all agreeing to lose their separate and independent existence and to become subordinate to one central organisation so that the interest of all may be merged into one and each becomes a part of the whole. It is also possible for the different parts to maintain their individual identity, each having an independent government and a separate existence of its own,

and yet, they may combine in matters external, that is, in activities in which the different parts are inter-connected, or in matters in which all have the same or common interest such as, army, foreign relations, foreign trade, etc. Such a form of union or combination by independent and autonomous powers is called a federal government. [Similarly, when independent and separate business units combine for common advantage in matters external, but in regard to internal affairs, the members retain independence and autonomy, it is called "federation." If, on the other hand, the different independent business units combine and are fused together to form a large concern and thereby both the external and internal management of all the combining units are brought under one controlling body, it is called a "consolidation."

From what has been said above it will be apparent that a consolidation has two features. One of them is to bring the entire management of all the combining units under one control or central organisation, and the other is that they should lose their independent and separate existence, all of them agreeing to fuse into one whole. When independent business units join together and become one, the entire management of all the combining units is automatically brought under one control. It is, however, possible to form a combination in which the entire management of all the organisations may be brought under one control without their fusing into one; yet each of them may retain its separate existence. Such a form of combination satisfies only one of the conditions of consolidation, and it is the most important one; for as a result of placing the management of all the combining units under a central body competition is brought under complete control and the chief

purpose of combinations at the present time is to limit or restrict competition. This form of combination serves the real purpose of consolidation; but as it fulfils the conditions only partially, it may be called a "partial consolidation." In cases where not only is the entire management brought under one control but the combining units are also fused into one, the combination is complete, and hence it may be called a "complete consolidation." "Holding companies" and "trusts" are examples of partial consolidation; "amalgamation" and "merger" of complete consolidation. There is no essential difference between a merger and an amalgamation, and the economic effects of both are the same. There is, however, some legal and technical difference between the two. A ("merger") is a form of consolidation in which one business organisation absorbs one or more business units within itself, whereas in an "amalgamation" the combining organisations give up their identities, become fused and coalesce into a new organisation.

**Illustration.**—A, B, and C are three companies. Two of them, *viz.*, B and C, merge into A. A thus absorbs the shares of B and C and is expanded into a larger concern, otherwise it continues to exist as before, and B and C go out of existence. This is "merger". But if all the three companies combine to form a new company, say, D company or "A, B and C company," it will be an "amalgamation." In amalgamation none of the combining units remain in existence and a new company is formed under a new name. In both the cases the ultimate effect is the same, *viz.*, that there is only one company in place of three and all of them are completely fused to form either a merger or an amalgamation.

## CLASSIFICATION OF COMBINATIONS

## I. Simple Combinations:

1. Association (direct combination of natural persons as in partnerships and joint-stock companies).

## II. Compound Combinations:

1. Association (the loosest agreements directly between individual members of different associations: trade "associations," some simple "agreements," etc.).
2. Federation (combination where two or more business units combine in one or more external aspects of the business, but each remains separate and retains independence in every other aspect: "price agreements" and "pools").
3. Consolidation: (combination of two or more business units such that the management of all the combining units is brought under one control, that is, they are fused so far as the management is concerned, though each unit may retain its separate existence).

## a. Partial consolidation:

- (1) Holding company (complete control of business units consolidated through stock ownership, with separate existence of individual business units formally maintained).

*b.* Complete consolidation:

- (1) Merger (complete consolidation, members of one or more business organisations absorbed by another).
- (2) Amalgamation (complete consolidation, members of two or more business organisations coalesce to form a new organisation).

**Trade and Industry Combinations.**—Combinations can also be divided from the economic point of view into ‘trade’ and ‘industry’ combinations. When two or more business organisations carrying on the same trade or manufacturing the same commodity combine together, the combination is called a “trade combination” because it unites organisations which are competing on the same plane, or which are in the same general line of business and are thus horizontal or parallel to one another. It is also called “horizontal combination” or “parallel combination.” On the other hand, when the combining units are carrying on different trades, or are manufacturing different products, such that the finished product of one is the raw material of the other, the combination is called an “industry combination.” <sup>Vertical combination</sup> For example, if a cotton grower, a spinning mill, a weaving mill and a tailoring business, each carrying on different trades within the same industry, combine together, the combination is an industry combination. The characteristics of an industry combination, therefore, are the following:—

- (1) the combining units must be carrying on business in different trades,
- (2) all the different trades must belong to one industry, and

- (3) they must represent successive stages or trades, that is, the finished product of one must be the raw material of the other.

An industry combination is also called a 'vertical' or 'sequence' combination, because the combining units which are carrying on different industries are on different planes and so represent the successive stages or 'trades' within an industry. These do not compete side by side, but stand end to end, the one receiving the products of the other as its raw material, or as in the case of an end-to-end combination of two railway lines, to form a single long line. An industry combination is also called an "integration."

In India there is practically no combination. In U.S.A. and in Germany, the home of combinations, cases of horizontal combination occur in plenty. This has been the most frequent type of combination and the most inveighed against by the public. A vertical combination is strikingly apparent in steel and tobacco industries. In the steel industry in America, the whole scope of the industry, from ore to rail or wire, is combined under one management. Similarly, in the tobacco industry, the growing, the curing, the manufacture of machinery used, the manufacture of snuff, chewing tobacco, cigars, cigarettes, tin foils, cans, packages, and finally the retailing of the finished product, all are more or less combined. In the tobacco industry England and America have practically the monopoly of the world market. The Imperial Tobacco Company of England has the monopoly in one-half of the world market, and its counterpart the American Tobacco Company in the other half.

The nature of a vertical combination is such that it can hardly make much progress except on a large scale, and it rarely occurs alone. Such a combination often re-



sults in serious competition, consequently, it becomes desirable to limit competition. The limitation of competition is effected by stretching out and combining with parallel business in the same trade. In a trade combination economies are many and varied and these we shall discuss at a more appropriate place under consolidation. In an industry combination also there is economy, as it saves capital in the storage, selling, buying, inspection, and transportation of materials between the stages. The real advantage of a vertical combination is that the combining members consume a certain supply of raw materials required and of requisite qualities and thus they guarantee a market for the whole or a part of the finished products to all the combining units in the chain of industries except to the first and the last. These two receive the benefit in one direction only, the former in the marketing of its products and the latter in the supply of the raw material.

#### CAUSES OF COMBINATIONS

Human nature is temperamentally individualistic, selfish and secretive by nature. This is the reason why people prefer to do things themselves, and agree to join hands with others only when they are compelled by circumstances to do so. In the early days of human inhabitation people wandered from place to place and lived by hunting, fishing and on fruits of trees. In their wild and lonely wanderings they were always exposed to the dangers of attack by wild animals and suffered many privations. They realised that in union there was strength, so they decided to settle down and build shelters at convenient places, in company with

others, to protect themselves from the ravages of wild animals and from the inconveniences of heat, rain, and cold.

In course of time, as civilisation developed and wants increased, people learnt the art of producing things and in the beginning they produced only what they required for their own use. Soon after this stage, they found the economic waste of such efforts and introduced 'division of labour,' according to which each man confined himself to the production of one or a part of one article only, and exchanged his surplus products for the excess produced by others of other commodities necessary for his consumption. With the increase in population, the widening of the market and the development of transportation facilities, production became more and more indirect and people felt the necessity of increasing the division of labour further till at the present time they have combined to produce in large quantities for consumers all over the world. In the beginning our business organisations were individual proprietorships, with one man as the sole proprietor and director. We have already seen how forced by circumstances to expand the business people combined with others for increased capital and better supervision, first into partnerships and then into corporations.

Man by nature follows the path of least resistance, and the same is true of capital. In India thirty or forty years before, men belonging to the educated middle class preferred jobs in government offices and as teachers in educational institutions. In the former there were security of service and reasonable prospects, and in the latter the work was comfortable and congenial. The more ambitious among them preferred the legal profession. Engineering and medicine exacted strenuous work, required more time and were expensive in the preparation stage, so few people

cared to go in for these. In course of time the supply in the first three professions increased much more than the demand, consequently the income of the members decreased. Naturally more people began to divert to engineering and medicine. In course of time these professions also became full, which increased the competition and decreased the income of their members. There was a time when people did not care to go in for mining engineering on account of the strenuous and hard life that it entailed, and the supply being less, the income was comparatively high. Consequently, low income, keen competition and hard struggle in the more suitable and congenial professions drove young men in large numbers to become mining engineers; but within only a few years' time the supply in it also exceeded the demand with the inevitable result that the income of the mining engineers decreased considerably. This proves the tendency of people to follow the line of least resistance and as the more comfortable professions became full and less lucrative, people resorted to more difficult and expensive professions in the hope of better prospects.

In the same way, in business as well, capital follows the line of least resistance. In the beginning there was plenty of land for cultivation, mines were unexplored and industries undeveloped. Man could easily take to any business according to his aptitude, convenience, training, ability, resources and ambition, there being plenty of scope in every business. As population increased, gradually all arable lands were brought under cultivation, some of the mines were exhausted and some others were under operation while industries and business developed all round. It can be said, in general, that the business which can be easily done, which does not require a large capital and in which

the risk of loss is less and prospects of income, at least, moderate, attracts people in large numbers and more capital is invested in it. With an increase in pressure all round, more people go in for the same business and the supply of capital in it increases till a stage is reached when profits diminish. In course of time production outstrips the demand leading to cut-throat competition, which considerably reduces the profit of the business and often results in losses. When the supply is very much more than the demand, the excess production remains unsold, and it is usually the less efficient producers who fail to find a market for a large quantity of their products and sometimes even the more efficient among them find that they cannot sell all. To continue in the business, therefore, results in loss, but the loss will be greater still to wind it up because the greater portion of the capital is in the form of machinery, buildings and other fixed assets and a forced sale of these properties is usually effected at a considerable loss. Sometimes they have to be sold as scraps and at a nominal price. The less efficient producers are thus between the devil and the deep sea because the closing of the business will mean a tremendous loss and its continuation is also a loss. We all live in the hope of better luck next time and are, therefore, encouraged to believe that there is nothing like trying. This wishful thinking encourages them to feel that by improving the organisation and by making the sales campaign more efficient and effective it might be possible to increase the sale. They are encouraged to take the risk of increasing the output and to borrow for these expenses to make a last effort to save them from loss. Sometimes they even increase the amount of their production to get the benefit of increasing return or decreasing cost, in the hope that if with a better and more

effective sale organisation, they can increase their sale, it will increase their margin of profit and this extra profit will wholly or partly cover the extra cost. The decrease in the cost of production may induce them to sell their products at a lower price to increase their sale and thereby to ensure their success in the competition market, and incidentally to increase the demand of the product through the fall in price. It is possible that one who takes the lead in this device may be able to derive advantage and may succeed to increase one's sale and also profit. But this increase in production will increase the supply further and make the competition keener still. If one producer is able to increase one's sale it must be at the cost of someone else because the demand will not increase in proportion to the increased supply. This is not all, because the example and the success of one producer will induce others to follow his lead and to increase their production too, and its effect on the total supply will be cumulative and will cause a further depression on the price of the commodity. The producers will no longer get the benefit of the decreasing cost, at the same time, on account of the increased supply the total quantity of commodities which will be left unsold will very largely increase and will be piled up in the godowns of many producers.

The continued loss to all, to some more and to others less, makes the producers realise that the total production being more than the demand, there is not enough room for all of them, and consequently, some of them must drop out and leave the business. But the question is, who should leave and go? It is not easy for anybody to leave the field and wind up the business because it means a tremendous loss to him. Those who started the business before claim on the basis of "first come, first served" that they have a right to

continue the business, that others who joined the business later are the real intruders, and are responsible for the increase in the supply beyond the demand and that these late-comers should retire in favour of those who started earlier. On the other hand, the late-comers contend that the criterion should be efficiency and not priority in starting the business. In the interest of all they maintain that inefficient business units should be wound up and that the field should be left clear for more efficient ones. According to them "the survival of the fittest" should be the criterion and the basis of determining who is to continue in the business. They maintain that this is the only fair basis. However reasonable the arguments of the latter might appear to be at the outset, the determination of who should continue may ultimately be arrived at through a painful process of cut-throat competition which lays everyone, high or low, more efficient or less so, open to severe loss. We have already discussed how this problem of the survival of the fittest leads to over-production and results in the undercutting of the prices. Every business man has to borrow a large portion of the working capital which he expects to pay off from the sale-proceeds of the finished products. But when large quantities of products are left unsold, creditors cannot be paid. Payment to creditors is essential for the maintenance of one's reputation and goodwill in the market. The unfortunate producers are, therefore, forced to sell their products at a lower price, maybe even below the cost of production, to pay off the creditors, to purchase fresh raw materials and to maintain the continuity of production. But no further production can be possible till the existing stock is sold. If the production is suspended, it will mean at least a temporary closing down of the business with all its

attendant losses because the overhead expenses have to be continued and there will be no source of income to meet them. Apart from this, the goods have to be sold and this they shall be able to do only at a sacrifice, and therefore, the sooner they do it the better for them as it means less loss. It is, therefore, obvious that no producer can afford to close down, or to discontinue production even temporarily, because in either case the loss will be very great and they would like to avoid it in the fond hope of overcoming the immediate and probably the temporary difficulties. They are, therefore, forced to sell their products at a lower and a competitive price to pay off the creditors. But if one party reduces its price others are forced to do so immediately. This leads to cut-throat competition and all, efficient and inefficient alike, suffer more or less from the consequent losses. It is not possible for all the producers to withstand such a loss from cut-throat competition for a continued period and in course of time the weaker and less efficient among them are forced to close down. The continued competition gradually eliminates the weaker producers and reduces the number of competitors. After suffering losses for a continued period they find that a free and unfettered play of the principle of survival of the fittest makes all of them to suffer loss, the more efficient also suffering along with the less efficient. The difference may be only in degree. The intensity of competition is so great that they are compelled not only to reduce the price, but also to sell below the cost of production. They ultimately realise that the producers really do not gain anything from such a free competition. If anyone benefits from it, it is the consumers. They naturally come to the conclusion that free competition does not serve its purpose, and that there is no advantage in reducing the price below

the level of minimum profit. But they would still maintain that survival of the fittest is the only just basis to determine who should continue and who should go out leaving the field clear for the more deserving ones, but with this modification that they should agree not to sell below a certain minimum price which should include a reasonable amount of profit. It is thus clear that producers are driven to combine in the natural course of business. Haney calls it *driving cause*. I would prefer to call it natural cause because the producers are ultimately led to combine in the natural course of business.

There are two other causes of combinations, but it will be clear from what follows that the 'driving' or the 'natural' cause is the primary and the most important one. As a matter of fact it can easily be said that this is the only cause, the other two merely helping business organisations to combine. When the supply of a commodity in a country is more than the demand, its price will fall, and as the supply increases the demand not increasing or increasing proportionately less, the price will naturally fall at a faster rate. The price may fall even below the cost of production. We have also seen that after suffering a considerable amount of loss, the competitors realise the futility of this price-cut war, and feel the necessity of arriving at an agreement not to sell their products below a certain minimum price. If the supply of the commodity in a country is from country-made and foreign goods, there can be no such agreement or combination among the producers and suppliers. The reason is obvious. Foreign producers usually send their surplus products to other countries, and their interest lies in disposing of these goods in any country except their own. This policy is known as 'dumping' and producers can afford to



sell at a considerably low price, even below their own cost of production and still remain gainers. To take an example, a foreign manufacturer can sell 1,000 units every day in his own country at a profit. Any increase in the supply will cause a fall in the price and will result in a corresponding loss to him. If the cost of production, when he produces 1,000 units per day, is Re. 1 per unit, and he sells them at Re. 1-4 as. per unit, he makes a clear profit of Rs. 250 per day. He now calculates and finds that by increasing the amount of daily production he will be able to get the benefits of the decreasing cost, and that by manufacturing 2,000 units a day his cost of production will be reduced to 12 as. per unit. If he were to sell the whole of the increased supply in his own country, it will certainly cause a serious depression in the price of the commodity. If the price is reduced to Re. 1 per unit, the manufacturer instead of losing will reap a harvest, as it will double his profit from Rs. 250 to Rs. 500 per day. The prospects are that the fall in the price will be more. If the price is reduced to 14 as. per unit, it will mean no definite loss, but no extra gain as well, because the total profit will still be Rs. 250. It will mean a loss to him in the sense that the increase in production will certainly increase the trouble for no advantage. In the event of the price falling below 14 as. per unit the loss will be definite and serious. He will very gladly double his output in order to take advantage of the decreasing cost provided that it will be possible for him to dispose of the extra production of 1,000 units per day in any other country except his own. Normally, his gain will be more than double. His profits on 1,000 units which he will sell in his own country will be doubled to Rs. 500 per day, and in addition he will be better off in the competition market in other countries not only

because of the reduced cost of production, but also because he will be able to make some profits on the extra 1,000 units of production.

The foreign producer decides to export the whole of the extra output to India, and assuming that the cost of transportation is 4 as. per unit, the total net cost of these products in India will amount to Re. 1 per unit. Let us suppose that the cost of production of the same commodity in India is Re. 1 and it was sold for Re. 1-4 as. before the import of the extra output referred to above. The increased supply will naturally depress its price in India, still the foreign producer will not be a loser, as a matter of fact he will be a gainer though the Indian manufacturers will have to suffer at every stage of the decrease in price. If the price is reduced to Re. 1-2 as. per unit Indian producers will lose 50 per cent of their profit, that is, they will now be making a profit of 2 as. per unit instead of 4 as. The foreign producer also will not be able to make a profit of more than 2 as. per unit, but his total profit will be considerably more. Originally he could make a profit of Rs. 250 a day only, whereas, in the course of the same transaction, he will now make a profit of Rs. 500 in his home market and an additional profit of Rs. 125 out of his exports, that is, a total of Rs. 625 per day. If, on account of competition, the price in India falls further and is reduced to Re. 1 per unit, it will create a serious situation for Indian manufacturers. It is true, that the foreign producer will not be able to make any profit from his export trade, but at the same time, he will not lose anything either; his income from the sale of the extra product will just balance its cost. His total profit will still be more than before, as it will be Rs. 500 in place of Rs. 250. If the price falls

further and is reduced to 14 as. per unit, it will mean that both the foreign and the Indian producers will be selling their products at below the cost of production. To Indian manufacturers it will be a dead loss, because they have no other source to compensate it, while to the foreign producer there will still be an advantage, though only nominal, because he will be able to make up for his loss in the foreign market out of an extra profit to him in his own market. His extra profit in the home market will be Rs. 250 and his loss in the foreign market will be Rs. 125 and this will leave him a balance of Rs. 125 as an extra profit, and his total profit will, therefore, be Rs. 375 in place of Rs. 250. If, however, the price falls further to 12 as. per unit, the foreign producer will have no advantage in taking the trouble and botheration to produce the extra amount as his total profit will be reduced to the original amount of Rs. 250 (Rs. 500 minus Rs. 250) per day. Till this stage is reached, the foreign producer can sell in the foreign market at a price below the cost of production and yet his total profit may be more.

The exporting of goods by a foreign producer to other countries and selling them there at a considerably reduced price, or if necessary, below his cost of production but incurring no loss thereby is known as 'dumping.'

The manufacturers in India will suffer a severe loss on account of considerable fall in the price of the commodity as a result of dumping by the foreign producer, and yet they will not be able to combine and come to an agreement with the latter not to sell below a certain minimum price. The reason is that it is against the interest of the foreign producer to combine, because the effect of such a combination will be to raise the price. A combination, as we have seen, would enable the manufacturers in India to

sell more and to that extent the sale of the imported goods will go down. The primary interest of the foreign producer is to sell the whole of his extra product and this he can afford to do at a much lower price and still make some profit out of it. If he fails to sell the whole of it in the foreign market, he will be forced, either to sell the unsold portion in his home market, which will have an adverse effect on the price of the commodity and on his profit; or he will have to reduce the total amount of his production, which will not permit him to get the full benefit of the decreasing cost. In either case he will lose. This is the reason why a foreign exporter is not at all keen on combining with the manufacturers in India, and if he does not combine no useful purpose can be served by Indians combining among themselves. The purpose of combination is to sell at a higher price, and as long as the foreign producer will sell at a lower price it will not be possible for Indians to sell at a higher price in the same market, hence it will be futile for them to combine.

If, at this stage, the Indian Government changes its policy and decides, in the interest of the particular industry, to impose an import duty, the price of the commodity will increase in India by that amount. If the duty be 6 as. per unit, the foreign producer will be compelled to sell each unit at Re. 1-2 as. which will leave him a balance of only 8 as. per unit. We have already seen that though at this price he will not lose anything, he will not be able to make any extra profit from it and, therefore, the extra production will not be worth the trouble and risk involved therein. To make some profit he must sell his product for more than Re. 1-2 as. per unit, say, Re. 1-3 as. or Re. 1-4 as. At these prices Indian manufacturers will be

able to make almost a normal profit. If the duty is high enough, it will exclude import altogether, or it will, at least, prevent dumping by foreign producers. If, with the help of the import duty, profits of existing producers become high enough, the business may attract new capital. It will be against the interest of the existing manufacturers to allow new companies to be started to increase the supply of the commodity and to depress the price again to a prohibitive level. To prevent such a contingency, the instinct of self-preservation requires that the local manufacturers should combine to prevent any new business from starting and establishing itself. It is only through combined and concerted action that they can prevent new business from being established in the country and if one is started, they would oust it by undercutting the price. It will not be possible for a new business to stand the loss of selling continuously at a prohibitively low price. When the new business man retires or the business is wound up, the old members have the market again at their command and can make up the past loss by raising the price. This is the reason why it is in the interest of the existing members to combine soon after the imposition of the import duty. It is not true that the import duty always leads to combination and why it does not we shall discuss under "Trusts."

{ From what has been said above it is clear that so long as free imports are permitted, combination among local producers is not possible. The imposition of an import duty, however, creates an economic situation whereby it may become possible for the existing members to combine and make it effective in order to safeguard their interest against any future contingency. An import duty, therefore, beckons or gives indication to the parties concerned to avail them-

selves of the opportunity and to combine. It is a cause of combination but as it does not always lead to combination, it cannot be called an original cause. It is only a helping cause. It must be clearly understood that so long as the supply is not more than the demand, and the ground has not been prepared through cut-throat competition for the competitors to realise the futility of price war and the desirability of combining, a tariff wall by itself cannot lead local producers to combine. Hence, tariff has been aptly described as the *beckoning conditions*. The history of the sugar industry in India in recent years is a proof of the above statement. The industry suffered a heavy and continuous loss before the imposition of an import duty on account of the competition from Java and other cheap foreign sugar. After the levying of duty on sugar the manufacturers in India did not combine as the economic condition was not ripe for such a combination. Foreign sugar was practically cut off. This enabled our producers to clear their old stock, and they made up their past losses and began to earn high profits. A sudden withdrawal of foreign sugar from our market created a gap in the supply of the commodity, and the prospect of high profits induced capitalists to start a large number of companies. The economic conditions described above clearly indicate that there was no demand for a combination among the sugar producers in India, and if they had combined it could not have been effective and lasting, the real demand being for more mills and more production.

Before the advent of the corporation or the joint-stock form of business organisation, business units were either partnerships or individual proprietorships. They were small in size, consequently, they were more in number. Joint-

stock companies have helped the combination movement by making each unit a very large one. Apart from the size of companies they have other characteristics which may permit two or more companies to combine easily, but the same thing cannot be said of partnerships or of individual proprietorships. It may be possible for any one partner to frustrate a combination approved of and agreed upon by other partners. This is not so in the case of companies. The approval or disapproval of a few shareholders does not count in the least, so long as the majority of the directors of the combining companies desire and agree to combine. Even if the directors disagree, it may not be impossible for interested parties to purchase enough shares in each of such companies to control the election of directors. By the possession of anywhere between 10 to 25 per cent of the total shares of each of the companies, a group can easily control the election and can get its nominees elected as directors of each of the companies. Joint-stock companies, therefore, facilitate combination in two ways:—(1) They bring together a large number of persons and a large aggregation of capital into one business unit. (2) Two or more companies can easily combine together as explained above and they do not have to get the approval of all the shareholders, nor even to gain the consent of the organisations which they desire to combine. The joint-stock form of company organisation is a third cause of combination. It is also not an original cause, it is only a *facilitating* cause. Thus there are three causes of combination:—(1) the driving or natural cause; (2) beckoning conditions; and (3) facilitating conditions.

**Pre-requisites for Effective Parallel Combination.**—Previous discussions indicate clearly that when the supply is more than the demand and there is over-production,

it leads to cut-throat competition and the resultant losses make the producers feel the necessity of combining among themselves to eliminate competition or, at least, to reduce it. A combination, then, between two independent and competing producers will always be the result of a compromise, because the interests of one will be different and, therefore, in conflict with the interests of the other. Each must compromise and be willing to sacrifice some of his advantages in order to reach an agreement, so that, both of them may derive the maximum benefit. When the number of competitors is very large, the conflicting interests will increase proportionately and the members will be required to sacrifice more for an agreement acceptable to all. Such an agreement is not easily reached and, even when arrived at, cannot be close and so cannot be effective and lasting. It is, therefore, obvious that if an effective and enduring parallel combination is desired, the competitors must first be reduced, by competition, to a manageable number.

The chief aim of a combination is to restrict competition so that the producers may not be forced to sell their products below a certain price as is the case under free competition and to enable the members to earn a reasonable amount of profit. If this profit attracts new business, there will again be competition, prices will fall and the combination will, therefore, become ineffective. It will not be possible to establish a new business where a large amount of fixed capital is required. In conclusion we can, therefore, say that where it is easy to establish a new business unit, competitors will spring up and effective combination will be difficult.

We have been told and we have also read in books that



there can be no friendship on a basis of equality between the rich and the poor, or between the strong and the weak. It is equally true of business alliances. If the competitors are of very unequal strength, the combination is not generally effective. The weak members are dissatisfied and tend to undercut prices; the strong tend to gobble the weak. Similarly, if there are several trades or stages in an industry and some produce in one or two stages only and others in several or all the stages, it is necessary that all of them must be equally strong or on the same level of efficiency in each of the stages in which they operate; otherwise their interests may conflict with one another in the various stages of production and, therefore, an effective and lasting combination may not be possible. In conclusion, it can be said that before an effective and lasting combination is possible, the number of competitors must be reduced to a manageable figure and this can be achieved in two ways:—(1) by a competitive struggle for survival eliminating the weak; and (2) by a process of amalgamation among the competitors so that each may become large and strong. Either of the two ways may serve the purpose.

**Some General Principles of the Legality of Combinations.**—Individual persons, partnerships and companies may combine together either partly or wholly. In the case of a company there are restrictions on the nature of work which it can do and it is limited by the objects as given in its memorandum of association; but there is no such limitation imposed on individual proprietorships and partnerships, because they can change their objects as and when it suits the convenience of the parties concerned. This is the chief difference among combinations and is dependent on the nature and character of business organisation.

The chief object of combination is either to restrict competition or to derive certain economic advantages by the combined efforts or to achieve both. It is the duty of every government to give all possible facilities to encourage the growth and development of industries and trade in a country; and it is equally their duty to see that none of the facilities or conveniences to any one industry or trade lead to or cause disadvantage, inconvenience or loss to another industry or trade, or to consumers and others. Combinations might lead to monopoly, restraint of trade and conspiracy, and these might or might not adversely affect others or put them to a loss; it is their result or effect that is harmful. As a precaution against such an eventuality, every country has restrictive laws to prevent monopoly, restraint of trade and conspiracy from exercising their baneful influence.

Monopoly is control over price based upon control over supply. At common law the prevailing doctrine is that monopoly will generally be declared illegal. But there are instances in history of exclusive grants from sovereigns. At the present time also exclusive rights are granted to public utility service companies which are authorised to carry on a monopoly business. Electric supply companies in different towns in India and in other countries furnish excellent example of this. Patents and copyrights also confer on their owners the exclusive right of business. In all these cases exclusive rights are desirable and necessary for people in general. A supply company must operate efficiently and should not fail in its service. If two or three companies are allowed to operate at a place, it will inevitably lead to cut-throat competition and the result will be deterioration in their service and might even cause a breakdown in the supply. This will inconvenience the public and

it will also affect industries which depend on the supply companies for their power. It is, therefore, necessary to give to the power-houses and to other public utility service companies exclusive rights of operation, but the conditions invariably laid down are that they will maintain their service efficiently, that there will be no unusual break-down, and that the rates will be reasonable and subject to alteration by the authority of the government.

In the case of patents the exclusive right is given to encourage people to devise new machines, etc., in order to improve the method of work or to increase production so that the cost of production may be lowered. A discoverer of a specific remedy or medicine may relieve human suffering. Copyrights encourage thinkers to write useful and instructive books to increase knowledge and to broaden the outlook of the readers. The exclusive rights which we have described above give monopoly privileges to the parties concerned; but it does not harm anybody, on the other hand, it increases the benefits and advantages of all. Such a monopoly is, therefore, desirable, and public policy requires that it should be legal. Monopoly can, therefore, be divided under two heads:—lawful and unlawful. Whether a monopoly is lawful or not will depend upon public policy. Acts which are against public policy are unlawful. Some monopolies involve acts against public policy; therefore they are unlawful. It is on grounds of public policy that public utility service companies, patent and copyright owners are authorised to carry on a monopoly business.

The same rules apply in the case of “restraint of trade.” Any contract which limits freedom of exchange or restricts markets is a restraint of trade. Such a contract itself does not affect the legality of the combination as such.

A contract in restraint of trade has also two aspects as in a monopoly, *viz.*, whether the contract is over and above the act of combination or it concerns the combination itself. For instance, when a retiring competitor agrees not to set up in the same line of business for a term of years, it does not concern the combination itself. It is over and above the act of combination and, therefore, does not affect the legality of the combination as such. The question of restraint of trade arises only when it concerns the combination itself. As in the case of monopoly the operation of restraint is based upon public welfare, and the law recognises reasonable as well as unreasonable restraints. If it be found injurious and against public policy, it should be declared unlawful, and, if found beneficial, restraints of trade may be held reasonable and lawful.

A conspiracy may be defined as a combination "to do an unlawful act, or a lawful act by unlawful means." The law is the same whether the parties to the conspiracy are individuals or firms or companies. Two conditions are essential in a conspiracy:—(1) concerted action; and (2) unlawful intent, either to do unlawful acts or to use unlawful means. An act by itself is not unlawful because the same act may be lawful in certain circumstances and unlawful in others. For example, it may be quite lawful for any individual to refuse to buy of any dealer but if several persons take, a concerted action and refuse to purchase from a particular dealer or dealers, it will be an unlawful conspiracy. The cumulative effect of the concerted action is the basis. Whether an act is a conspiracy or not depends upon the intent to do an act forbidden by law or to do damage, expressed in some agreement. Design in common is the essence.

Business combinations themselves are not illegal as conspiracies because the primary object of such combinations is usually the benefit of their members, and, unless it can be proved that their intent is primarily to injure their competitors or others, or to do some unlawful act, they are not conspiracies. If the object or the necessary result of combination is directly or indirectly to control prices or to restrict freedom of exchange, by itself it is neither a conspiracy nor anything unlawful; but if it is to the detriment of public interests, it is unlawful, being against public policy. It will be doubly so when necessities of life or public utilities are concerned. Public policy, therefore, is the most important factor for deciding whether a business combination is lawful or unlawful.

## CHAPTER VI

### FEDERATION ORGANISATION.

Federation is an alliance of separate and largely autonomous organisations for mutual benefit in relations which are chiefly external to themselves. "Associations," "agreements," and "pools" are the different classes of combinations and each is an alliance of separate and independent business units. Federation organisation can, therefore, be divided into these three classes of combinations.

In our discussion of the causes of combinations we found that the struggle for the survival of the fittest makes people realise the necessity of an agreement among themselves not to sell their products below a certain price. Such an agreement is the result of a concerted action by the competitors. It interferes with their individual independence and restricts competition among them. We have also studied another class of combination where business men combine to form a "trades association," such as, chambers of commerce, etc. The trade association is an association of business men in a single trade or industry or a group of closely related trades. It does not involve any agreement or concerted action of a specific character. It is essentially educational. Its general purpose is to improve the position of the members as business men engaged in the trade, by establishing better conditions within the trade, and protecting it against adverse outside influences and extending

its activities. The essential difference between the two is that in the trade association there are no concerted action with regard to the business organisation, no loss of individual independence and no restriction of competition and no collective control of the quantity of output to be marketed, as are found in agreements. The "pool" is a special kind of agreement, it includes all the features of agreements and is something more.

A federation has two features:—(1) it is an alliance of independent businesses into an association; and (2) in one or more of the external aspects which concern the organisation itself, the competing units combine together and become one. These are the essential features of a federation. A trade association is an association and satisfies the first condition only but not the second. It is, therefore, not a federation. We can, therefore, divide the three classes of combinations discussed above into two groups:—"associations" and "federations." A federation includes both "agreements" and "pools."

**Agreement Organisation.**—When two or more business units enter into an agreement for a common course of action, an association is automatically formed. Some measure of association is, therefore, essential in order that an agreement may come into existence or function. This is the reason why it is said, that "agreements" involve "association," but they do not necessarily involve "an association," i.e., a particular form of association such as a "trade association." They often exist outside any trade association. The form of organisation within which the agreement is made is not the essential feature. The real factor is in the intent or in the acts of those who make the agreement.

Broadly speaking or from an economic point of view agreements can be divided into "trade-conditions agreements" and "price agreements."

**Trade-Conditions Agreements.**—The chief aim of most agreements is to influence prices though in many cases fixation of prices is not the direct and primary object, and some do not relate to prices at all. Agreements, therefore, may concern various conditions of trade, such as terms of credit, methods of packing and shipping, dealing with competitive products, advertising, transportation and labour supply. We may call them "trade-conditions agreement."

In England, for example, "the sale note adopted by the National Association of Millers prescribes the terms of delivery, the duration of the contract, the date of payment, and the adjudication of disputes. The charter party or contract for hire of a vessel adopted for various trades by Chambers of Shipping contains stipulations as to loading, conduct of the voyage, and method of payment. The primary object of these agreements is the avoidance of disputes by the transaction of business according to settled forms, but they also insure that competition shall take place in the open without secret rebates."<sup>1</sup>

Some trade-conditions agreements have no connection with a trade association. They generally exert a somewhat greater effect upon the business conduct of their members than do commercial organisations like chambers of commerce.

**Price Agreements.**—"Price combinations" are numerous and, in addition to prices, frequently cover trade conditions. From what has been said in connection with the

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<sup>1</sup> Macrosty: *The Trust Movement in British Industry* (London), 1906, p. 6.



—Jagat Singh Bisht.—

causes of combinations it is clear that when the supply is more than the demand, there is not enough room for all the producers and some of them must go out and wind-up their business. It is but natural that the weaker ones will be forced to leave the business and for this natural process of elimination, the producers pinned their hope on the theory of the survival of the fittest through price agreements. We have seen that free and unfettered competition leads to cut-throat competition. They think that the price agreement will solve the problem because they will no longer be required to sell their products below the cost of production. The better-managed concerns which will be able to sell more will make enough profits and the less efficient will sell less and after some time will have no option but to close their business. (But things do not always move according to plan and we have already discussed the reasons why the losing concerns do not and cannot wind-up their business, because the winding-up of a company entails a greater and a permanent loss. Besides, the immediate problem for such producers is to pay the creditors and the only way in which they can pay them and keep the firm going is by selling the products. If these cannot be sold at the price agreed upon, the producers will have no option but to sell them at a lower price.)

The same process of under-cutting prices is repeated with price agreements as well, the difference being that in case of agreements the evil day is postponed for some time because in the beginning all try to maintain the price and work according to agreement. (As the demand is less than the supply, and it will correspondingly decrease at a higher price, a time will soon come when many producers will find a large quantity of finished products left unsold. These un-

fortunate producers, for reasons already explained, will be forced, maybe against their wishes, to sell them at less than the agreed price.) (If one person does it, others will have no option but to follow, and a cut-throat competition will ensue. To prevent this under-cutting of prices price agreements are sometimes formed with a sales association.) Even in the case of sales-association agreements, there is no restriction of the aggregate output, and no apportionment of that output among the members. The output is merely turned over to a sales manager who disposes of the whole. The income is distributed through the common sales agency according to the unrestricted output of the individual members.

It must be obvious that the existence of a sales association does not very much affect the result, for the purpose of a sales association is to prevent under-hand dealings. But what can a producer do if the sales association cannot sell all his products and as a result a larger quantity of them is left unsold in his godown? He has, therefore, no option but to sell directly at a lower price. Thus a sales association cannot very much, as we said above, alter the situation. In either case the agreement breaks down. They now realise that the struggle for the survival of the fittest, however sound it may appear in theory, does not serve the purpose. It does not help them to reduce the supply and so long as the supply is not controlled and everybody is free to produce as he likes, the supply can never be reduced and brought to the level of demand and till this is done no amount of pious wishes and agreements to prevent the under-cutting of prices will carry them anywhere because uncontrolled production will invariably lead to overproduction and this in turn is bound to result in cut-throat competition. In the circumstances they are forced to give up their faith in the

efficacy of the principle of the survival of the fittest, of driving away the less efficient producers out of the business in order to reduce the supply, and to take a more realistic view of the situation, *viz.*, that each producer must be prepared to sacrifice something and with this end in view all of them must agree to produce less in order to keep the supply equal to the demand and till this is done it will never be possible to control prices and protect the producers from undergoing the resultant losses.

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**POOLS**

The purpose of every business is to earn profits and the need of controlling the supply is to restrict cut-throat competition to ensure these profits. This is based on the idea that if the total production of all the producers put together is equal to the demand, each of them will be able to sell almost all that he will produce and naturally each will have his full share of profits. This can be achieved, directly or indirectly—directly, by making the total production equal to the demand, and indirectly, by dividing the entire market into zones and assigning to each one or a few of these zones. The former controls the supply and the latter the market; but the result of both is the same, which is to ensure sale and, through sale, profits. The total amount to be produced by all the producers put together is regarded as a fund and out of this fund each of them is allotted a certain quantity to produce. Thus all the producers pool together and create a common fund of their total production, which is called an "output pool." It is called a

"traffic pool" in the case of railway companies. Similarly, the whole market forms a fund and is divided among the producers on some agreed basis and this is called a "market pool." The same purpose is achieved by collecting the income of all the producers into a common fund and then apportioning it to each from this fund on an agreed basis. If the fund is composed of gross profits, it is called an "income pool" and in the case of net profits, it is called a "profits pool." (An industrial pool, then, is a form of business organisation established through federation of business units whose members seek a degree of control over price by combining some factors in the price-making process in a common aggregate and apportioning that aggregate among the units.) Some degree of control over supply is always involved and this control is exerted more or less directly according to the type of the pool.

The combination movement thus reaches the next higher stage in its evolution. The determination of the amount of production by each producer is an aspect of the business organisation of individual business units and when this is done jointly by all the producers, as is the case when the control of supply is decided upon, naturally one aspect of the management of individual units is put under a common control or management. In none of the combinations we have so far studied, there was any such control of the business organisation itself of individual business units; each was free and independent to produce as much as he liked, to sell wherever he could and make whatever profit was possible. In a pooling organisation the restriction of the supply means that each producer will not be permitted to produce more than a certain maximum amount. Here is a restriction in the very organisation and the amount of

production by each is put under common control. In every other sphere each is independent and may be competing with one another. This is the essence of a federation.

The pooling organisation, particularly the output and the market pools, made everybody very hopeful and the members felt that at last the millennium was reached, that there would be no more cut-throat competition; as a matter of fact they wondered why they had not thought of it before. But all is not gold that glitters and the millenium they had hoped to have attained proved a mirage. When they attempted to work out a detailed plan, they came across many difficulties.

**Output or Traffic Pools.**—An output pool is one in which the members combine to the extent of making their outputs—traffic in the case of railways—form an imaginary aggregate fund or pool, and then divide that pool among themselves on some agreed basis. This kind of pool operates on the supply side of the market; it seeks to control competition by restricting the aggregate output. This is the rock upon which many a price agreement has split, for how can prices be maintained or raised if it continues to remain to the advantage of the individual members to increase the output and they are left free to do so? The output pool is adopted primarily to avoid “over-production.”

There are two factors in the output pool—(1) to determine the amount of demand in order to fix what the total supply should be; and (2) to distribute this total or the aggregate output among the producers, in other words, to assign to each the amount which he should produce. The total demand was determined by finding out and aggregating the sale that each of the producers had within a certain period in the immediate past. There was an inherent defect

in such a course as the sale during the previous period was governed by the cut-throat competitive price when the demand was certainly much more than what it would now be at a higher price. The real purpose of regulating the supply was to increase the price in order to make the business remunerative but at this increased price the sale was bound to be correspondingly less, the degree of decrease depending upon the elasticity of demand and supply of the commodity. This was the first defect of the output pool because the supply was fixed at a level higher than what the demand would actually be. This was not all, because the task of the combining members was not only to fix what the supply should be, but also to distribute this total estimated output among the producers, which was not so easy to do as it appeared at the outset. All the producers put together were now to produce much less than what they were doing before and naturally each of them wanted to get for himself as much of the share as possible.

They could not divide it equally among all the members because some were large concerns and others small. The division was to be on a certain principle and the difficulty was in fixing this principle or basis. There were two or three bases of distribution and each producer wanted the one in which he would have the greatest advantage.

① Capacity of production is one method. Let us assume that the capacity of production of all the producers put together is 1,000 units per day and it is decided on the basis of demand that the total production will only be 500 units per day. This means that each of them will produce half of what he can. This cannot satisfy all and for valid reasons. Let us now suppose that the capacity of production of A and B, two producers, is 100 units each per day. A was pro-

ducing 100 units before and B, 80. On the basis of the capacity of production each will be allotted 50 units per day. A is not satisfied because he gets 50 per cent of his actual production whereas B gets  $62\frac{1}{2}$  per cent. A feels, therefore, that an injustice has been done to him because B who was not able to produce more than 80 units per day, and had wasted so much money in purchasing machines and other equipments which he could never utilise, was getting the benefit in spite of his folly. A, therefore, claimed that the division should be on the basis of actual production and not on the capacity of production. Let us take another example where A produces 100 units and sells 50 units whereas C produces 80 units and sells 60 units. If the allotment be on the basis of actual production, A's share will be 50 units and C's 40 units. A whose efficiency is 50 per cent has been allotted cent per cent production, that is, equal to his selling capacity, whereas C whose efficiency is 75 per cent has been penalised and has been allotted a production of two-thirds of his selling capacity. C is justified in claiming that the distribution should be on the basis of efficiency or ability to sell and not on the actual production or on the capacity of production.

Thus there are three methods of distributing the total estimated fund of output:—according to the capacity of production; according to the actual amount of production and on the amount of sale. None of these methods suits all equally well. This is a constant source of trouble and makes an effective combination very difficult, though to make the best of a bad bargain they have to agree to the method which suits the majority. It goes without saying that the method which is based on the efficiency or ability to sell is, the most reasonable and the best, but that the best does not

always get the support from all or even from the majority. It is a question of personal interest and the amount of influence one can exert to bring others round to one's viewpoint.

A very great hope was centred on the efficiency of the output pool to solve the difficult problem of over-production and the consequent cut-throat competition, but it did not succeed because none of the methods adopted in allocating the amount of output to each producer gave equal satisfaction to all. But the real difficulty was that the total amount of output still remained greater than the demand and in variably resulted in cut-throat competition.

**Market Pools.**—As long as producers are free to sell anywhere and the supply is greater, cut-throat competition is bound to be the result. They, therefore, thought that the best course will be to organise the combination in such a way that there will be no competition among them. This could be effected (by dividing the whole market into smaller areas or markets and allocating one or more of these areas or markets to each producer so that he will have a monopoly of sale in his market.) This will also obviate the difficulty of fixing the quota of output for each producer as is necessary in the output pool. Because there will be no competition and each will have a complete mastery in his market, he will have the freedom and opportunity to adjust the supply to the demand: hence there would be no necessity of restricting the output of the members. Such an arrangement ensures a certain demand to each member and also restricts the supply by keeping the members away from other sections and confining them to their own fields, and is called "market pools."

The only economy in the output pool is that by restricting production, the waste and losses resultant from cut-throat



competition due to over-production are reduced. In the market pool there are other economies in addition to this. The area for sale in a market pool for each producer being exclusive and limited, much of the advertisement cost can be saved as it need not be extensive and members can also concentrate their sales campaign within the area at a less cost and with better results. (They can easily feel the pulse of the market and adjust their supply, both in quality and quantity, according to the needs of the consumers. On the other hand, consumers are not in favour of a market pool because it deprives them of their freedom to purchase the articles of their choice and forces them to buy a particular quality.

The division of the market among the producers is not less difficult than the distribution of the output. One has to spend a large amount of money as it takes time to build up sales and to create a market for one's own articles. People, therefore, do not like to give up markets which they have built up at a great cost and sacrifice. This objection is not so strong because the loss, if there be any, is more than compensated by the gain which one derives from an exclusive control over other markets. The real difficulty is in the division of the markets as it is not an uncommon feature for two producers to claim the same market. As in the case of output pools, in the market pool also members are never satisfied with the allocation of the markets. Apparently, a market pool seems to be a better method of combination but its success depends upon the members confining themselves to their own areas and not trying to invade others' markets.) But greed and selfishness very often lead producers to encroach upon others' markets, though they would resent when their markets are similarly invaded.

Sometimes they may do it against their wishes; when some yield to the temptation and encroach upon others' markets, others have no option but to retaliate. Whatever it be, the result is the same everywhere—a breakdown in the agreement which leads to cut-throat competition and loss to every producer.

In the beginning all the producers confine their sales within their own markets. By intensive advertisement and also by making the sales organisation more effective, the producers expect the demand to go up and in anticipation of an increased sale they increase their production. Production is also increased to get the benefit of decreasing costs. The capacity of production of each member is already more than the demand, they are not required to purchase new machines and other equipment or to exert much in order to increase their production. But there is a limit for the demand to increase and it cannot materially increase particularly when the producers do not want to give any benefit to the consumers by reducing the price. As a result of this when they find that a large quantity of products is left unsold, they try to dispose of the surplus product in other markets at a cheaper price instead of increasing the supply in their own markets where it is sure to depress prices. They forget for the time being that its effect will be retaliation, that the whole agreement will collapse like a house of cards and that all will have to suffer from the adverse effects of cut-throat competition.)

✓ **The Basing Point System of Prices.**—To avoid the difficulties of dividing the markets, [the wire nail pool in the United States of America introduced an indirect method of dividing the market by the “basing point system of prices.” A central town is made the “basing point.”] If the cotton

textile trade in India desired a market pool, Cawnpore may be made the "basing point." The price at any other point will be fixed at a figure which will be equal to the Cawnpore price plus the railway freight from Cawnpore to that point. Thus the closer the mill to the point in question, the greater will its profit be; while mills farther removed from Cawnpore will not be able to sell at this point at all. If the cost price of a unit of cloth at Cawnpore is one rupee and the freight to Allahabad is two annas, its price at Allahabad from any mill will be fixed at one rupee two annas, and Cawnpore will automatically hold the Allahabad market against Ahmedabad, Bombay or Calcutta, at least as long as the basing point price is maintained. This is true for mills at distant places as far as the Allahabad market is concerned. But there will be no such difficulty for mills at Cawnpore and other neighbouring places in selling cloth at Ahmedabad, Bombay and Calcutta. Mills at these places will not be free from cut-throat competition. (This method of dividing the market gives protection to producers at certain places but not to others.)

**Income and Profits Pool.**—(Both the output and the market pools failed to achieve their purpose; and the failure in each case is due chiefly to over-production and to the excess of supply over the demand.) The consumers were particularly against the market pool as it interfered with their freedom to choose the article of their preference. Producers, therefore, adopted another method called "income pool," which would be less subject to the criticism and would, at the same time, assure some profits to every one, allowing none to earn more than a certain maximum. There are two features of an income pool, viz., (1) to fix an output for each member as in an output pool, and (2) to fix a cost

price from time to time. The purpose of fixing the quota of output for each producer is not to prevent him from producing and selling more than the allotted amount, but only to limit his income. According to this scheme one will be allowed to produce more and sell more so that the consumers may have no grievance. A "cost price" sufficient to cover expenses of production is retained by the members and the difference between this and the selling price is paid into the pool. After deducting the expenses of maintaining the pooling organisation, the balance is divided among the members according to the allotted output. When the deduction is the cost price, it is called a "profits pool" and when it is less than the cost price it is known as an "income pool."

## CHAPTER VII

### HOLDING \* COMPANY \* ORGANISATION

The discussion about the different types of pools has clearly demonstrated that unless the supply which is the price-making factor is brought under the complete control of all the combining units put together, there will always be temptation for individual business to increase the supply, a rock on which all "pools" have foundered. To prevent underhand and secret practices by individual members there is only one method, which is to bring the entire management of all the combining units under one control, so that no loop-holes may be left. This can be achieved in two ways. Either all the combining units should amalgamate and be fused into one in the interest of all, or the individual units may still remain separate; but the interest of at least the controlling number of shareholders of each business should be combined and so merged together that the direction and the management of all the separate organisations is in the hands of one central body. The former is called a "complete consolidation" and the latter a "partial consolidation."

A partial consolidation is formed in two ways; one is "holding companies," and the other is "trusts." Orthodox economists do not include trusts in the category of combinations for reasons which will be explained later when we take up trusts. For the present we shall discuss holding companies only.

**Holding Company Organization.**—A company is organised as a manufacturing concern or for some other business to earn profits for its shareholders. It sometimes invests its surplus money in the securities of other companies as an additional source of income. {When a company purchases these securities with a view to control the direction and management of these companies, it is called a "holding company." } If a sugar mill, for instance, purchase the shares of other competing sugar mills in order to control the management of these companies, it will be called an *operating holding company* or a *mixed holding company*; whereas, if a new company is organised to purchase and hold the shares of the different competing sugar mills, it will be called a *pure holding company.* }

In every company there are some large shareholders and when a company fails or does not earn profits, these shareholders suffer the loss more because of their large holdings. It becomes necessary for them to devise methods to prevent the loss. (The failure of pooling organisations and price agreements to control over-production and the loss from cut-throat competition made these large shareholders of each of these companies feel the necessity of pooling their resources by organising a holding company to consolidate the management of all the competing companies.)

Let us suppose that there are six sugar mills A, B, C, D, E and F and all of them are competing with one another and they are all losing because of the cut-throat competition. Now, the larger shareholders, viz.. A', B', C', D', E' and F' of the respective companies organise a holding company X (figure 1). Its chief purpose is to control the management of these six companies by holding a controlling amount of shares of each. A', B', C', etc. exchange their holdings of

the respective companies A, B, C, etc. with the shares of the X company. This exchange is an outright sale. The X company becomes the shareholder of all the six companies and A', B', C', etc. are no longer shareholders of the companies A, B, C, etc. and all of them become the shareholders of the X company only. The directors of the X company will elect their own nominees as directors of each of the six

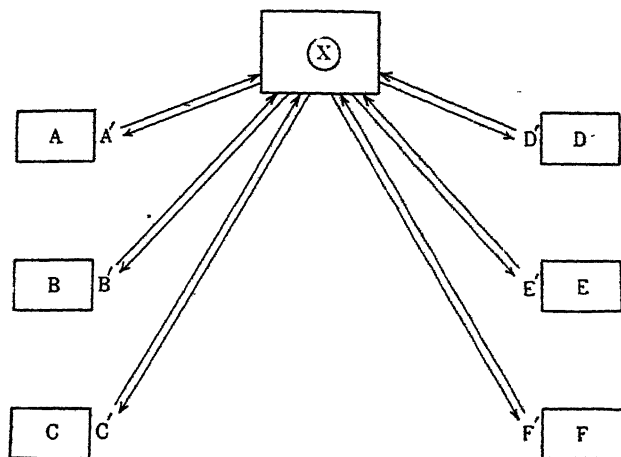


Fig. 1

companies. The controlled companies remain nominally independent and operate under their own names, but are effectively managed by the officers of the holding company. In case the holdings of the X company in the shares of any of the six companies are not adequate to control its election, it will purchase in the open market additional shares of the company concerned to make its control effective. In order to obtain the additional capital required for this

purpose the holding company sells more shares than the combined holdings of A', B', C', etc.

(The market value of the shares of each of the six companies is not the same.) It can, therefore, be asked, on what basis the shares of the respective companies are exchanged for those of the X company. The market value on any future date cannot be taken as the basis as it is subject to manipulation. They also cannot adopt the value on any date in the past as the basis, because the market value on any one date may not reflect the real value. They, therefore, decide that the daily average value of the last one month or so should be the basis of exchange. If the value of the shares of the A company is Rs. 105, of the B company Rs. 100 and of the C company Rs. 95, these will be exchanged for the shares of the X company in the following proportions:—20 shares of the A company for 21 shares of the X company; 20 shares of the B company for 20 shares of the X company; and 21 shares of the C company for 20 shares of the X company.

The economic significance of both the partial and the complete consolidations is the same, they differ slightly in detail, which we shall discuss under complete consolidation.

Instead of organising a separate company X the combining shareholders could expand one of the existing companies, say, the A company and exchange the holdings of B', C', etc., of the respective five companies with the shares of the A company. The rest is the same. In this case the A company will be called an operating holding company or a mixed holding company. Again, if the A company has the controlling shares of the B company and B is controlling C, and similarly, if D is controlling E and E is controlling F, a holding company need be organised by A' and D', share-



holders only of the two companies respectively (figure 2). They may organise a separate holding company, or one of the two companies A or D may be expanded for the purpose.

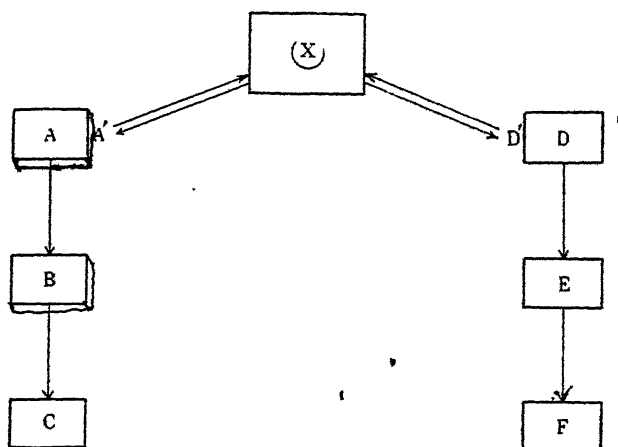


Fig. 2 .

### INVESTMENT COMPANIES

There is a similar organisation called "investment companies." They also purchase shares of different companies but do not have control as their purpose; they may even desire to avoid it. Such an institution is very useful to those investors of moderate means who usually do not have the requisite knowledge to select securities properly and cannot differentiate the good securities from the bad. For a sound investment a few elementary principles must be observed by investors. One should not invest a large amount of money in the shares of one company only, or in several companies in the same industry, or in different

industries in the same geographical area. If the investment is in the shares of one company only and the company fails the investor may lose the whole or a major portion of his money. Similarly, if the investment be in different companies in the same industry, the investor may lose, though in a lesser degree, if the particular industry as a whole suffers loss on account of a new phase in the competition or for some other reason. Again, if the investment be in different industries but in the same geographical area the investor may lose if industries within a geographical area suffer a similar disaster. This is the reason why it has been considered wise to purchase shares in different companies, in different industries and in different countries or in different parts of the same country. This is known as "diversification" of investments. An investor, particularly one of moderate means, can neither make a proper selection of securities nor can he get the benefits of diversification of investments by direct and independent investments. This difficulty can be obviated by an indirect investment through an investment company. Such a company engages the services of experts who understand the prospects of different companies, in different industries and in different parts of the country and also the intricacies of the money-market to select suitable industries and the most appropriate securities to earn the maximum amount of profits for its shareholders.

In the case of direct investment when a person invests a large amount of money in the shares of one company and it fails, he loses a large amount of his capital. Instead, if the investment is indirect and one purchases the shares of an investment company, the probability of such a loss will be little. The experts employed by the investment company have the knowledge of selecting the best securities and of

companies which ordinarily will not fail, and if ever any of these companies fails, the loss to the investment company itself will not be heavy because its investment in the securities of any one company is always proportionately very little. Consequently, the loss to the individual shareholders will be almost negligible. Apart from this, such a loss, if there be any, will be more than compensated by the appreciation in the value of other securities purchased through judicious and sound investments. This compensating effect can rarely be obtained in direct investments by individual persons. From the point of view of income also there is a distinct advantage in such an investment. A company may not fail but from time to time it may not be able to earn sufficient profits to give dividend to its shareholders who will be very much inconvenienced for the low income or its total absence. In the case of indirect investment through an investment company the shareholders will never have to face such a situation. Some companies may earn less and others more in any one year, but the total income of the investment company will not differ very much from year to year and, therefore, the income of its shareholders will be more or less constant. The diversification of investments thus ensures a good and regular income to the investors and this one can get to the maximum extent by purchasing the shares of an investment company. Investment companies are, therefore, of great advantage to investors and also render a great service to the industrial development of the country. They are a great check on the reckless promoters and encourage investments and the promotion of companies in the proper direction.

**Difference between a Holding Company and an Investment Company.**—The characteristic difference between an investment company and a holding company is that

an investment company has no choice for the shares of particular companies in a particular industry. It purchases shares of different companies in different trades in order to obtain the maximum advantage for its shareholders with the minimum risk. The primary aim of a holding company, on the other hand, in purchasing shares of other companies is to control the management of those companies and it desires to control the management of those companies with which it is in competition. It, therefore, makes it a point to purchase shares enough to control the votes of certain companies in the same trade. It may be necessary for a holding company to purchase shares of a losing concern or to have to pay a higher price than it deserves in order to induce the holders to sell, but this an investment company would never do. The immediate aims of the two are different and distinct though the ultimate purpose of both is in fact the same, i.e., to obtain the maximum benefit for their shareholders. A holding company wants to control the management of other companies in order to reduce competition and to increase profits to its shareholders.

The Finance Holding Company is a holding company the primary function of which is to make profits by financing the operations of other companies through promotions, underwriting, or re-organisation. Incidentally it may exercise more or less control over the companies which it finances, but this is not its main purpose, and the control is generally temporary—during the financing period only. Nor is the income from dividends or the interest received on investments the chief consideration.

## CHAPTER VIII

### COMPLETE CONSOLIDATION

“Amalgamation” and “merger” are the two forms of complete consolidation. When two or more companies join under a new name and they lose their separate existence the combination is called an amalgamation. For example, if two companies, A and B, combine under the name of company C, and cease to exist as A and B, the consolidation will be an amalgamation. If the two companies desire to retain the old names they can do so by combining the names and calling the new company ‘A and B company.’ For all purposes it will be a new name and a new company. Amalgamation thus results from the creation of a new company by the coalescence and virtual disappearance of a group of business organisations.

**Merger.**—A merger is a consolidation in which one business organisation is absorbed by another that retains its own existence. In a merger the combining units do not form a new company, one of them continues to exist and all the other companies merge into it. If there are three companies, A, B and C, and they combine so that any two of them merge into the third, the combination is a merger. For example, if B and C merge into A, or A and B merge into C, or A and C merge into B, in each of these cases the consolidation will be a merger. In a merger, therefore, a new company is not formed, and all the combining organisations

except one—the one which continues to exist—lose their separate existence.

They differ in their methods and in the technical process of approach, but the purpose and the effect of both, amalgamation and merger, are the same. They combine the interests of the competing companies and their shareholders in such a way that they are all fused together into one complete whole.

(1) In an amalgamation the capital of the new company is made large enough to purchase the shares issued and held by all the shareholders of the combining companies; and in a merger the capital of the company which continues to exist is enlarged to purchase the holdings of all the shareholders of the remaining companies. In actual operation, in the case of an amalgamation, the shares of all the combining units are exchanged for those of the new company and in a merger, the shares of the remaining companies are exchanged for those of the company into which all the other companies merge. The purchasing company, as the result of this process, becomes the absolute owner of the properties of all the companies, and may continue or suspend the business theretofore carried on by them, and otherwise manage the affairs without restriction or supervision except by its own shareholders. { We can, therefore, define a complete consolidation as a form of business organisation which is established by the outright purchase of the properties of constituent organisations and the merging or amalgamating of such properties into a single business unit. } Complete consolidation is, therefore, a combination through sale. It is a union in which the parts are fused and lose their identity.

To effect an amalgamation or a merger the following

procedure must be followed. The directors of the constituent companies meet together to settle the terms of consolidation as to the capitalisation of the consolidated companies and the method of exchanging its securities for the shares or properties of constituents. The agreed proposal is then submitted to members of each of the combining units for their assent at a properly convened extraordinary meeting and if the required majority favours the step, a certificate or articles of consolidation, together with copies of agreements of the shareholders, are submitted to the court for its approval. No consolidation can take place without the sanction of the court and mere provision for it in the memorandum of association of the constituent companies is not enough. If the court approves of the agreement for consolidation, the order of the court together with the certificate or articles of consolidation and the agreements of the shareholders are filed with the Registrar of Joint-Stock Companies for the registration of the relevant documents and in case of an amalgamation for the incorporation of the new company.

**Difference between the Holding Company and a Complete Consolidation.**—The holding company retains the separate existence of the combined organisations and controls them by voting their stocks. It cannot act directly for all the companies and whatever it wants the other companies to do it must get done through the directors of the respective companies. It is, therefore, a partial or temporary consolidation. The nature of the holding company organisation is such that the constituent members must be joint-stock companies and the relationship is between individual shareholders of the companies and the holding company. In a complete consolidation the combining units are no

longer separate and independent, they fuse together and become one. The question of controlling them does not arise because they are now one. It is not necessary that the combining members must be joint-stock companies, they may as well be partnerships and individual proprietorships, because complete consolidation does not depend upon stock-holding. Usually the constituent elements are companies and the relationship is between the companies as such, and not, as in holding companies, between the shareholders as individuals and a company which combines their organisations indirectly by combining their shares. A pure holding company merely holds stocks and does not operate or directly manage the combining concerns; the complete consolidation, on the other hand, is an operating unit and manages all the concerns directly. In the holding company only a few shareholders of the constituent companies may combine and this may result in the creation of conflicting interests between the two sets of shareholders—those who join to form the holding company and those who are not in the combination; but this is not so in a complete consolidation where the combination is of companies and not of individual shareholders and therefore the interests of all the shareholders of all the combining companies are fused together and are alike.

**Difference between Consolidation and Sale.**—We have found that in a consolidation there is a sale of the entire property of each of the combining concerns to a consolidated company. This does not necessarily mean that the sale of the property by one business organisation to another is always a consolidation, which depends upon the purpose and the interest of the vendor continuing in the property after the sale. If the interest of the owner or



owners in the property which is transferred or sold terminates, it is a mere sale and not a consolidation. But if, instead of the interest ceasing, it results in a union of interests in the properties of the combining concerns and among their owners, it is a consolidation and so is more than a sale. In other words, if the shareholders of the vendor company retain an interest in the united properties, it is a combination and not a mere sale.

### **Advantages and Disadvantages of Consolidation.—**

Let us suppose that six companies, manufacturing the same commodity and competing with one another amalgamate into one company. Such a combination will have many advantages. A manufacturing concern must purchase raw materials, these raw materials must be manufactured into finished products and the finished products must be sold. Such a company must have at least three departments—the purchase department, the production department and the sales department. If the business is on a small scale, one person may be in charge of all the departments, but with every increase in the size of the business, a more elaborate arrangement has to be made and one person may be appointed as the head of each department with assistants to help. Presuming that the size of each of the six companies is just large enough to have one purchase manager, one production manager and one sales manager, over and above them, there will be one person co-ordinating the work of all the three departmental heads and responsible for the business and the administrative side. He may be called a general manager. Every manufacturing concern must have at least these departments and in addition it may have one or two more departments as the nature and the size of the business and several other factors may demand. The

modern conception is that a manufacturing business must have a research laboratory of its own to test the quality of the raw materials purchased and sometimes the quality and the strength of the finished product as well. A glass factory, for example, whose chief raw materials are sand, soda and lime, must know the chemical properties of these, or rather the impurities in them in order to add the necessary chemicals in their proper proportions, so that the quality of the finished product may be as desired. The large-scale production of the present time coupled with competition keeps the producers alive to the need of improving the quality of their product and to devise methods to reduce the cost of production. To effect this scientists must be engaged, laboratories must be equipped and experiments must be made to find out a better process, so that the quality of the product may be improved and the cost of production reduced. There was a time when the manufacturers used to laugh at the suggestion of a research laboratory and experiments. Past experience has taught that not only are these experiments useful but they have also become a necessary adjunct in the modern large-scale factory organisation. In Europe and America, companies which are not large enough to afford a separate establishment of their own get the work done by part-time men, usually professors of local universities. But modern large-scale factories all over the world have laboratories of their own. The Tata Iron and Steel Company at Jamshedpur has a well-equipped laboratory. A manufacturing concern has still another department called the engineering department. There are factories which have power-houses of their own. Apart from this practically every factory must have a machine shop, a repair shop and a smithy for repairing tools and other equipments.

There are thus five departments and we shall now study the advantages of consolidation in each of these departments.

**Purchase Department.**—We have already supposed that the company is large enough to have departmental heads, and we presume now that each purchase manager is paid Rs. 200 per month and, therefore, the total amount paid by all the six companies is Rs. 1,200 per month. When all the six companies are consolidated and become one company, it will no longer require one purchase manager for each factory. One purchase manager for all the six factories may do the work with a senior assistant at each place, and probably with greater efficiency. It will thus save the salary of five purchase managers and, therefore, they can afford to pay a higher salary to engage the services of a better expert who will increase the efficiency of the purchase department. This purchase manager may make purchases for all the six factories and issue directions from a central office, and at each factory a senior record keeper, acting under the instructions received from the purchase manager, may serve the purpose and send him reports from time to time. If before the amalgamation they had one purchase manager and one junior record keeper at each place, they will now engage a senior record keeper in charge of the purchase department at each factory for which an extra Rs. 50 for each place may be more than enough, and if the expert purchase manager has to be paid Rs. 500 per month there will be a distinct saving of Rs. 400 per month, besides other economic advantages which the consolidated company will be able to derive from the services of the better and more efficient purchase manager. Here are the additional economic advantages. One company will now be purchasing for all the six

concerns. A large-scale purchase has its own advantages and the purchaser can get better rates, better credit facilities and all these will effect savings in handling and other charges. Not only will there be a saving in salary but economies will also result in many directions.

**Sales Department.**--A similar arrangement will be made and economies effected in the sales department also. In place of six sales managers there need be only one sales manager with six senior sales record keepers at each place. Here, too, this will result in saving in salary and increase in efficiency. The sales manager will arrange for the sale of the product of each factory from his central office. The sales department will be able to effect many other and effective economies in the sales organisation.

Before the combination all the six companies competed with one another, as a result of which several of them simultaneously advertised in the same paper and also sent salesmen to the same places and thus the duplication of expense in connection with the sales campaign was many times more. Consolidation immediately stops all this duplication. There need be only one advertisement in one paper in place of six, consequently from the saving thus effected, the quality of advertisement can easily be improved and made more effective. Again, instead of six salesmen visiting the same place in order to book orders from wholesale and retail dealers of the town, only one salesman need go. He will sell the products of all the six factories and the purchasers will be at liberty to select the articles of their choice. The time that the salesman will be required to stay at each place to book his orders will now be less than before, for when salesmen from several rival companies visit the same place, the dealers thereof naturally take more time

to decide their purchases. They like to set one against the other to get the benefit of the competitive price, and then, they also know that the salesmen cannot afford to go away and even if one goes away there will always be others to purchase from. This fear of losing customers to the rival concerns makes the salesmen wait patiently. None of these things are possible when the rival companies combine and become one. The dealers will, therefore, not take unnecessary time to decide their purchases. Consequently the time which a salesman will be required to devote at each place will be less. This will reduce the cost and will increase the efficiency of his service. ✓

**Production Department.**—From the nature of the work it appears that there cannot be similar economy in production as is possible in the purchase and the sales departments because production cannot be conducted by one person from a distant place. The production expert must be present all the time to inspect the quality of the output and to make necessary adjustments. There can, therefore, be no economy under the head of salary because no reduction in the number of production experts is possible. This does not mean that there can be no economy in other directions. The following instances will show that large economies are possible herein also.

Take, for instance, a leather industry which has two distinct manufacturing sides—tanning and leather goods manufacturing. Let us suppose that there are two companies A and B in two different towns and both are engaged in these two sides; that the amount of capital of both the companies is the same; that both are doing well; and that each is making a net profit of  $7\frac{1}{2}$  per cent. After several years of successful operation, both of them decide to introduce cost

accounting which shows that A is making a profit of 10 per cent in tanning and 5 per cent in leather goods manufacturing, while in the case of B it is just the opposite, i.e., a profit of 5 per cent in tanning and 10 per cent in leather goods manufacturing. The amount of capital on each side being the same, the average profit to each company is  $7\frac{1}{2}$  per cent.

In spite of this revelation it may not be possible for them to give up the weaker side and concentrate wholly on the side in which each is strong, for there are certain economic advantages of retaining both and some disadvantages of discontinuing one. The tanning industry ensures a certain supply of leather and that of a particular quality to the leather goods manufacturing section and the cost of its transportation and handling charges from the tanning section to the manufacturing is practically nil. The tanning section is also assured of a definite sale of either the whole of its product or of at least a major portion. Thus each side derives benefit from the other. The question of prestige and the loss in closing down any section are of course other difficulties.

If at this stage the two companies decide to amalgamate, they will reap all the advantages and suffer very little from the disadvantages. The result of such a combination will be that they will concentrate on tanning at the A factory and on leather goods manufacturing at the B factory. All the machinery of the tanning section can be transferred from the B factory to the A. Similarly the machinery of the leather goods manufacturing section can be transferred from the A factory to the B. The question of selling them at a loss will not arise as it will be effected by means of book transfer only. The cost of transporting the machinery from each of the factories to the other will be more than counterbalanced by the additional profits that each factory will now be able

to earn. The only loss will be that soaking pits and other tanks at B which were needed for tanning purposes cannot be transferred and will be rendered useless there and additional pits and tanks will have to be constructed at A. The net result of the consolidation will be that A will confine its activities only to tanning and B exclusively to leather goods manufacturing, and thus each will concentrate on the work in which it has the maximum advantage. The B factory will still be ensured of a regular supply of leather and of requisite qualities and the A factory will be certain of the sale of its products. Finally, the effect of such a concentration will be that profits at each factory will easily increase to 10 per cent and in all probability it will be more on account of the benefit of large-scale production.

In the **Engineering Department** division of work and concentration are not possible because repairs, as may be necessary from time to time, must be done at each place.

**Research Department.**—The economies in the research department will be effected under the heading of salary, as in the purchase and sales departments, and also in several other respects. Continuing our illustration of the A and the B companies it can easily be presumed that there is a laboratory at each factory where researches are conducted in the two sections of the industry—tanning and leather goods manufacturing. There are thus two laboratories with four experts and at least four or more assistants and researches are conducted in both the laboratories practically on the same subjects or in the same directions. After amalgamation they will still maintain the two laboratories but the one at A will confine its researches to tanning and that at B to leather goods manufacturing only. This will put a stop to duplication of research and will reduce the



number of experts to half the original number. Before the amalgamation not only is there a duplication of research because both the companies conduct research on the same topic, but also when something new is devised or found out by one, it remains a sealed knowledge to the other, which continues to spend money and energy on the same experiment. Being rival companies, they do not give out the results of their researches and each tries to keep the new knowledge secret as long as it is possible. This is a dead loss to the companies concerned, to the consumers and to the country as a whole. From the savings effected by amalgamation, it may be possible to engage the services of expert research workers of a higher calibre who will be able to find out new methods and new devices to improve the quality and the quantity of the products in less time and at a less cost. This saving will be three times more when in place of two there are six companies competing with one another as in the original illustration. If more than one factory carries on the same operation, all of them will derive benefit from the new knowledge acquired, a thing which would never have been possible without amalgamation.

We have already seen that the real cause of cut-throat competition is over-production. Under free competition not only is the actual production more than the demand, but the total capacity of production of all the producers put together is greater still. The consolidation merges the interest of the shareholders of all the companies, it is, therefore, immaterial whether profits are earned more from one factory than from the other. For the same reason, it will now be possible to close down one or two factories and run the others to their full capacity. The overhead expenses will thereby be reduced and consequently the cost of producing goods.



This will permit the sale of the surplus machinery and thus release a part of the locked-up capital which may be utilised in some useful productive purpose to reduce further the cost of producing goods.

We should discuss not only the advantages of consolidation to the combining companies, but also their effects on all those who come in contact with these companies and on the country as a whole. The producers of raw materials, the labourers, the investors and the consumers are the different parties and their interests are vitally mixed up and in many cases, dependent on the nature and the effect of the consolidation.

**The Producers of Raw Materials.**—We have already seen that as a result of combination the consolidated company gets the benefit of purchasing on a large scale. This by itself is not objectionable and sellers do not stand to lose anything thereby, but it may be quite different when the consolidated company is in a monopoly position as a buyer because in this capacity it will have the advantage of setting one producer against the other and may put all of them to a loss. Such has been the case with the Standard Oil which fixes the price of crude petroleum, and the great beef and meat-packing firms control cattle prices over large areas of the United States.<sup>1</sup> The buyers can adversely affect the producers only when there is over-production because, the supply being in excess of the demand, a cut-throat competition is bound to ensue, irrespective of whether the buyers are in a monopoly position or not. The monopoly position of the buyer by itself cannot, therefore, affect the producers adversely though it may intensify the competition and thus

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<sup>1</sup> Hirst, *The Story of Trusts*, p. 214.

put the producers to a greater loss. The real cause is over-production for which they alone are to blame. The solution for the producers is to combine in order to control the supply and that is the only effective protection for them.

**Workmen.**—Workmen are interested in their employment, in the continuity of their employment and in wages. When there is yet no combination and the employers are separate and distinct, a workman who leaves the service of one company can expect to be employed easily in another; but this is not possible after the consolidation though the number of factories may still be the same. Usually workmen are not expelled except for bad conduct and inefficiency. But at a time of depression production is reduced and some men are necessarily thrown out of employment. When the depression is all round none of these workmen can expect to be employed in any other factory, but if it is confined within a limited area only, workmen can hope to be employed at other places and the amalgamation of companies is no bar to such employment. Experience has shown that workmen from one branch have been employed at another branch.

Those who are opposed to consolidation say that, as it causes unemployment among workmen, it is prejudicial to their interests. The advocates of consolidation, on the other hand, claim that this is not quite true. They admit that the immediate effect of consolidation is that many men are thrown out of employment and that is bound to happen because the primary object of consolidation is to reduce over-production. Over-production is the cause of employing more men than the industry really needs, and when depression comes, as it is bound to, some men are thrown out of employment. It takes time to learn a trade and after getting the necessary training and after working in it for

some time, it becomes difficult for one to leave it and take to another. This becomes still more difficult on account of the off-and-on employment in the existing trade which keeps them in hope of better times, but the net result is that the average period of employment is certainly reduced: consequently the average wage earned by them per day is also less. Combination aims at decreasing the supply permanently and this is effected by reducing production, which permanently throws out of employment a certain proportion of workmen. In this weeding out the least efficient men are selected. When workmen come to know that there is no hope of re-employment in the same business, they will naturally take to some other trade in which they may hope to be employed permanently. Those who will be put out of job will have a very bad time indeed but the loss and the difficulties will be temporary as against a regular off-and-on unemployment. Once a workman has selected a new and a suitable trade, he will no longer have to face the difficulties of such periodical unemployment. His daily average income will increase. This will enable him to increase his own efficiency and also that of the future generation. The consolidation, therefore, will bring a definite advantage to the more efficient workmen, and for those who are less efficient, if judged from a long-period point of view, it will ultimately be to their advantage and not against their interest as is usually supposed.

The assertion that workmen enjoy the benefits of a continued service when employed by consolidated companies is not correct and cannot stand the scrutiny of facts and in support of this contention instances are cited from history that in consolidated companies employment has varied during business cycles. There are several theories of the causes

of business cycles and no one has up till now succeeded in proving to the satisfaction of even a good majority of thinking people its real cause, and much less, its remedies. The business cycle has been accepted as a natural phenomenon and people have resigned themselves to their fate to meet the situation as best as circumstances would allow. When a trade is affected by the business cycle, production is reduced and it results in unemployment. But this unemployment is found both in consolidated and also in non-consolidated companies, and as a matter of fact it is always less acute in the former.

The employers might take advantage of the unemployment among the workmen as a result of consolidation and may reduce their wages. In course of time things will themselves get adjusted to new conditions and Trade Unions will prevent the employers from having their own way.

**Consumers.**—It is true that the price which consumers have to pay now is more than what they were paying before consolidation, and this is what it should be because the combination is aimed at eliminating or reducing the cut-throat competition. A business is organised to earn profits and if its products are to be sold below the cost of production, the owners will lose and the business may have to be closed down. This may result in unemployment and may also affect other producers, and it is the duty of society to prevent, if possible, the inconvenience and loss to its members. If the production is stopped or reduced, the consumers may be deprived of the article, or they may be inconvenienced for not getting the product of the requisite quality, or they may have to pay a higher price. It is not in their interest to pay varying prices. A steady but reasonable price is better for the consumers than varying prices, at times low and at others

high. A consolidation certainly makes the price steady and regular. Of course during a business cycle the price is bound to be affected and will be lower at one stage of the cycle and higher at another. But this is an exceptional circumstance over which business men as yet have no control.

It is said that the consolidated companies do not charge the same price in all markets. They charge a lower price in markets where there is competition and to compensate this loss they charge a higher price in others. This is true, but is it not equally so of all business and even when business organisations are not so combined? Whatever may be the remedy be, at least one thing is certain that the prevention of consolidations will not and cannot stop producers from charging different prices in different markets so long as it is to their advantage and is possible. The remedy, therefore, does not lie in preventing consolidation, but in creating a situation so that the producers may not be able to charge discriminating prices in different markets. This can be effected by maintaining competition in all the markets.

It is said that the producers of raw materials in order to maintain the high price of their products in their own country may adopt a cheap export policy to sell the surplus product in foreign countries at a very low price. These foreign purchasers will be able to manufacture goods at a cheaper price and compete easily in the country from where the raw materials come against the producers there because the cost of production to the latter is more on account of the high price of the raw materials. It can easily be imagined that such instances are few and far between and in the few cases where they may occur, measures may be adopted to protect the producers from undesirable foreign competition. Further, one must not forget that there are two sides to

every question and for a little disadvantage here and there one must not forgo and sacrifice the many advantages of amalgamation.

**Investors.**—One of the chief aims of investors is a regular and steady income from their investments. They do not favour much fluctuation in the market price of the securities in which they have invested. They therefore want to invest in securities which will not only be a source of a regular and steady income to them, but also ensure no capital loss if and when they might be in need of selling the securities. It may be argued that there may be an equal chance of extra gain as a result of a rise in the price of the securities. But one should not forget that investors are not speculators. They do not want to lose in the capital value of their securities. The question that arises is whether the securities of the consolidated companies are speculative or steady. The value of securities rises and falls consequent upon the soundness of the financial position and the prospects of their profits. When there is a cut-throat competition among several companies, every one of them suffers loss, their profits are less, some may have no profits at all and others may have to meet the losses from their capital. The market price of these securities is bound to fall and will also fluctuate from time to time. But with consolidation the conditions will change, the income will increase, profits will be more and regular and the financial position will improve. The market price will rise in the beginning and then become steady with very little fluctuations. Thus it is clear that the securities of the consolidated companies will suit the investors better. This may not be so in the case of partial consolidations, as will be evident from what will follow a little later.

We have studied several advantages and a few dis-

advantages of consolidation. The chief advantage is that it gives the benefit of a large-scale production, and eliminates cut-throat competition. The larger the scale of business the greater is the return and the lower is the cost of production. This increasing return is obtainable up to a certain limit of expansion, beyond which the return begins to decrease. A factory can, therefore, be of a certain maximum size, which may be called an "optimum" size. In the same way, several similar factories can be joined together under one management and the advantages of such a combination will be more than the total advantages of all the several factories put together. In this case also, there is a limit up to which the number of factories can be joined together under one management. Consolidation, therefore, may be desirable and can be pushed only up to a certain limit.

Competition and rivalry are desirable; they are the pep of business and must be fostered and kept active because they spur men to be more active and resourceful. Competition is healthy and must be encouraged, but the same thing cannot be said of cut-throat competition which is like a cancer in the business body and, if not eliminated or brought under control, is bound to destroy all around it. The only remedy is consolidation but the danger of such a combination is that it may become a monopoly power. Consolidation does not necessarily involve monopoly but it may lead to it. We must have all the benefits of consolidation without its disadvantages. This can be achieved by encouraging combinations in such a way that there may be a few consolidated companies to maintain competition and rivalry. This is not impossible to achieve. Consolidation of banks is more dangerous than that of industrial or commercial companies, yet it is very useful when there are

several competing consolidated banks, as is the case of the five big banks in England.

The holding company can also get the same advantages in all the four departments, *viz.*, the purchase, the sales, the production and the research. It will appoint experts for each of these departments and levy charges from each of the combining companies on some reasonable basis. These experts will be the employees of the holding company. It is easy to form a holding company organisation. As an alternative, either all the shares of the subsidiary companies should be purchased or they may be purchased to form a consolidation. There is a difference between these two. Mere purchasing of securities requires no consent or approval of anybody, but when the purchase is to form a consolidation it must go through a series of processes. The directors of each of the companies must agree to the terms of consolidation which should then be passed by the shareholders of the respective companies by a requisite majority at a meeting specially called for the purpose, and finally it should be approved by the proper court and this last approval is not always easy to obtain. When such a permission cannot be obtained and if an attempt is made to buy the subsidiary companies outright, it might be rendered futile by the unwillingness of a few individuals to surrender the separate existence of the organisation in which they are interested; but the formation of a holding company requires no consent on the part of the stockholders of the subsidiary companies, for the promoters may merely buy up stock in the open market until they get a controlling amount. All that is necessary to finance the deal is to sell securities or exchange them for those of the company to be controlled, and, as a bare majority holding is generally all that is need-



ed, the amount of capital required is reduced to a minimum.

The secrecy which may attend control through stockholdings has also been an advantage from the private point of view, and such combinations as the American Tobacco Company have controlled plants unknown to labour unions and customers who would have discriminated against them, had the "trusts" stockholdings been known.

The nature of the holding company organisation divides the shareholders into two distinct groups: those belonging to the holding company, and others. To the holding company it is immaterial whether profit is more from the A company or from the B company so long as the total profit to it from the two companies put together is the maximum. It may be to the advantage of the holding company to run the A company full and the B company only partly instead of running both at equal strength. This may be to the advantage of the holding company but the other shareholders of the B company will lose thereby. Incidentally it may be an advantage to the other shareholders of the A company but that is no consolation to the other shareholders of the B company. There is no such trouble or inconvenience to any one shareholder in the case of a consolidation because the interests of all the shareholders are merged into one and are identical, and it is immaterial to them whether A runs at its full strength or B runs only partly or C is closed altogether. In the case of a holding company the closing down of one company is not easy, if not impossible. It will mean at least a voluntary winding-up of the company. The other shareholders of this company will lose, and the loss to the holding company as its shareholder will be more than compensated by the extra gain from its holdings in other companies.

**Social Point of View.**—If society accepts 'big business' as desirable, the best way to bring about the evolution lies through complete consolidation. Judged from a purely economic point of view, it has all possible advantages. (1) It effects concentrated direction and all other economies that accrue to large-scale enterprise. (2) It removes also to a very great extent, if not completely, the defects of direction, in a holding company. In the latter, the same person may be a director of several companies and at the same time may also be the chief executive head of one of these. This would naturally result in his slackening in the matter of some of the companies, for it is not humanly possible for him to devote an equal amount of time and energy to all. When he slackens, an atmosphere of sluggishness and irresponsibility will pervade the whole organisation, bringing with it inefficiency and a steady deterioration. In a complete consolidation this cannot be. The directors' responsibility will be concentrated as there is now only one company into which all the others have fused, and the evil effects of direction will soon be a thing of the past.

(3) With regard to responsibility to the public or even to shareholders, the complete consolidation is decidedly superior to securities-holding organisation. In the one, the company acts directly and is controlled by a majority of all the shares involved, whereas in the other the combination is by holding controlling shares in each of the combining companies, and this combination acts indirectly through these holdings upon the constituent companies. In such a combination it is possible for a few shareholders only to effect the desired control by holding a small fraction of the total capitalisation. It is, therefore, evident that in the holding company the total power is lodged in a few; the total responsibility is spread

among many. In conclusion, it may be said that sound public policy demands the encouragement of complete consolidation by merger or amalgamation rather than by holding company. In the long run legitimate individual interests lie in this direction.

We have not discussed a "trust" as yet which, as has already been stated, is at best a partial consolidation. It is, however, interesting to reflect that with the complete consolidation we may be completing a cycle in the evolution of business organisation. We commenced our business organisation with individual proprietorship and, in course of time, it developed into a partnership and then culminated into a corporation or a joint-stock company as we have decided to call it. The joint-stock company has also passed through similar stages in its development, through several forms of combinations of companies, which have reached the final stage again in the joint-stock company. The new company, however, is a compound company, that is, a combination of companies built up through the consolidation of preceding organisations. All the different forms of compound combinations, *viz.*, agreements, pools, trusts and the holding company, will perhaps continue to exist side by side with the compound company, just as the individual proprietorship and the partnership have continued to exist beside the simple joint-stock company. It will probably be desirable to encourage the various forms of combinations with certain appropriate restrictions, just as it is best to encourage partnerships and individual proprietorships where they are effective. We have not reached the end as yet, and who can say through what new cycles business organisation must swing!

## CHAPTER IX

# TRUSTS

A Trust is an arrangement by which property is handed over to, or vested in, a person, in the trust or confidence that he would use or dispose of it for the benefit of another. Society felt the necessity of devising some suitable agency for managing the property of incompetent persons, of minors and widows. Sometimes people make a gift of property to an educational institution, to a hospital, or for other charitable purposes. The trust proper thus appears to have developed from the necessity of devising some suitable agency to manage these properties; and such agencies were early recognised at common law.

The owner of a property may decide to make a trust of the whole or only a part of his property, to be managed by the trustees either in the interest of the owner himself or his heirs or a charitable institution, as the case may be. He lays down conditions and necessary directions in a document called the 'trust deed' on the basis of which the trustees are to manage the property and to dispose of the income to the beneficiaries. He names the first trustees and the method of appointing their successors is given in the trust deed. The owner might appoint himself or one or more of the beneficiaries as trustees along with others. He or the beneficiary then manages the property as one of the trustees and not as the owner of the property.

Basically the trust idea involves the separation of the ownership of property in two parts, the legal title being held in one person's hands (the trustee) for the benefit of the persons (beneficiaries) who hold the equitable title. The property is managed by the trustees in the interest of the former title-holders who become beneficiaries. The trustees are not agents, like partners, but law has conferred on them the right to act as principals. They can make contracts, and can sue and be sued in their own names. The beneficiaries, in turn, are neither partners nor agents. During the life of the trust the beneficiaries have no right over the property, they cannot convey it to others. They are entitled to the income only. They have, however, the right of action against the trustees. With such a relation existing between trustees and beneficiaries, it is apparent that without any special provision to the contrary, the debts of the business lie against the trustees, not against the beneficiaries.<sup>1</sup>

Under common law, trustees may and do issue certificates of beneficial interest, the capital embraced in the trust being divided into shares. These certificates are much like the stock certificates of a business corporation.

Trusts in the business sense are a later development and originated in the United States of America about the end of the nineteenth century. They can be divided into association trusts, that is, trusts of property, and combination trusts, that is, trusts of business units. In the former, individual persons combine to vest in trustees the administration of property for the common benefit. In the latter, business units delegate the control of the units

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<sup>1</sup> Haney, *Business Organisation and Combination*, 1934, p. 130.

to the trustees, thus incapacitating the constituent organisations from determining the course of their own operations.

The trust in a popular sense is any big monopolistic combination, but as a specific business form it has a more definite meaning. "A combination trust is a form of business organisation established through temporary consolidation, in which the stockholders of the constituent organisations under a trust agreement transfer a controlling amount of their stock to a board of trustees in exchange for trust certificates. These certificates show their equitable interest in the income of the combination."

In certain respects a combination trust is like a pool. It is based upon the mutual consent of the members who sign a trust agreement and thus it involves a contractual relationship. Again, the dividends declared by constituent companies are collected by the trustees on the shares transferred to them by the members of the trust organisation. From the fund or pool thus created the members are paid in proportion to their interests therein.

But here the likeness ceases. The trust is much more than a mere pooling of income or dividends. The aim is to control the management of the combined companies and this is effected by giving the trustees power to elect their own nominees as directors of the constituent companies and thus to control their policies. Through common ownership of stock and direction of management the various units embraced are closely combined. They remain separate only in name, and for all practical purposes they become one as in the case of holding companies. In effect, therefore, trusts are partial consolidations.

The nature of the trust organisation is similar to that

of the holding company and the two differ in detail only. Continuing the illustration of the holding company the six companies A, B, C, D, E, and F with the six sets of shareholders, A', B', C', D', E', and F', may form a trust Y in place of organising and incorporating a holding company X. These shareholders, A', B', C' etc., draw up a trust deed and elect the required number of trustees to whom they transfer their holdings and thus a trust is formed. In exchange for the shares transferred to the trustees the latter issue trust receipts or certificates which serve the same purpose as shares in the case of the holding company X. The shares transferred to the trustees are valued on the same basis as are the shares in the organisation of the holding company. The trustees have the same power of electing directors of the constituent companies as the directors of the holding company have.

✓ **Voting Trusts.**—The "Voting Trust" is a kind of special trust designed to protect the interests of minority shareholders and the creditors of a company. It is a form of organisation in which holdings of shares are combined, by placing them in the hands of trustees, to be voted in a stipulated manner. A trustee, or a group of trustees, makes a contract with the shareholders providing that any of the shareholders of the company may deposit their shares and become parties to the agreement. Since their share is transferred on the books of the company to the voting trustees, the latter become the real shareholders and during the period of the agreement, vote at the annual elections and at special meetings. Voting trust certificates are given to the shareholders who become entitled to the dividends. The certificates are often listed on the exchanges. When the trust is dissolved the trustees exchange their share for the certificates

of beneficial interest and the shareholders thereupon become reinstated with the right of control.

Usually a voting trust must be limited in time, measured by the definite purpose to be accomplished. For example, if the debenture-holders of a corporation threaten to foreclose the mortgage securing their debentures, they may be induced to forgo this right by being given control of the corporation till their bonds are paid off. This can be done by the creation of a voting trust in which the trustees are nominated by the debenture-holders. In this way the debenture-holders would control the directorate of the company until their debentures have been paid off.

Unified voting is the object in voting trusts, and the ownership of stocks is not vested in the trustees: they are trusts of management, not of property. The trustees' receipts may be transferred without the voting of stock being in any way affected. In this way a dominant majority within a corporation may rest easy without fear of its holding being decreased, a minority may ensure a united front upon all occasions, or a whole body of shareholders may prevent outside interests from buying in and manipulating their company. The voting trust, however, may be abused by majorities, and may be used to further manipulative plans.

**Difference between a "Trust" and a "Holding Company".**—In the formation of a trust, the stockholders of the constituent companies surrender their stock to be held in trust for them by trustees. Thus they become the "beneficiaries" of a trust agreement. The shareholders do not thereby give up their interest in the shares altogether, they only surrender their right of control over their shares. In the case of holding companies the shareholders exchange their shares of the constituent companies



with the shares of the holding companies. In other words, they make an outright sale of their own shares of the constituent companies to the holding company and in exchange purchase the shares of the latter. Moreover, in the trust agreement a confederated relationship was involved, in which the parties maintained a nominally separate existence; but the holding company is a nominally responsible corporation, buying stock in the open market and doing that which the State has authorised it to do. Formally, this makes considerable difference between the two kinds of combination organisation. The combination trust is an agreement between an association of individual trustees and a group of corporations which by implication give up their autonomy and so act *ultra vires*: it involves dealings between corporations which results in partnerships between them. Formally, the holding company is a duly certified company, authorised to deal in the shares of other companies and to hold them; and its dealings are entirely with individual shareholders of the controlled companies.

The course of industrial development discussed in this chapter and the causes which led to the formation of different forms of combinations have made it amply clear that a time must come in many industries, in every country, when consolidation must be encouraged and trade unless controlled is bound to harm those very people in whose interest restraint of trade was made objectionable or unlawful. Is it not true that cut-throat competition is harmful not only to producers, but also to others—the producers of the raw material, the employees and through these the country as a whole? It is, therefore, imperative that the cut-throat competition should be eliminated and consolidation encouraged where and when necessary. The undesirable practices that were adopted

in the past by some organisers of gigantic corporations by amalgamation and by trust made many people feel that these organisations were not actuated by good motives and that the organisers were clever knaves. America is the home of the trust movement and it assumed an acute form there by the end of the nineteenth century and culminated in the passing of the anti-Trust laws. But we should not be prejudiced because some consolidations in the past were effected by undesirable men.

With the march of time economic conditions have changed, necessitating changes in methods, outlook and policy, not only in the industrial field but in almost every walk of life as well. There was a time when people had sympathy for workmen and the labour movement. But times have altered and with them the habits and necessities of life have undergone a tremendous change and because of these people now do not have unmixed goodwishes for all the activities and measures adopted by the trade unions. For instance, strikes by miners and railway employees are not liked now. The use of coal and travelling by rail have become part and parcel of our daily life and almost as necessary to us as food. The Governments now do not hesitate to declare strikes unlawful and dare do it only because they know that they have the support of the people. This shows which way the wind is blowing. From this one must not come to a hasty conclusion that people have no longer any sympathy for labour and the labour movement. They still have sympathies. But selfish that man is, he thinks and cares for himself first and then for others. So the people will not tolerate a strike if it interferes with their daily necessities. Even when the workmen's demand is just, they are not prepared to support strikes. This is the reason

for a new conception of nationalisation of industries, particularly of those industries which according to modern requirements cater to our daily necessities, such as, coal, power plants, railway, etc.

As changes have been effected in the political organisations of different countries from autocracy to democracy, similarly, in the business field also, the industrial development and the changes that have been wrought by it, during the course of a century and more, have made people realise that the time has come for restraining trade where unrestrained trade means the cutting of business throat and the wasting of business blood. The old idea of any restraint on trade must be discarded as a doctrine not suited to the present business conditions and business should be restricted to prevent over-expansion and over-production.

**Slow Growth of Combinations in India.**—People often ask, why is it that there is practically no combination among the producers in India? For a student of industrial economics it is not at all difficult to assign causes for the slow growth and development of combinations in Indian industries. In the opinion of the author the question is premature and out of place, as will be evidenced from the discussions to follow. One who understands the causes which lead to combinations and has a knowledge of the state and the extent of development of industries in India will emphatically say that barring solitary exceptions industries in India have not reached a stage when combinations are necessary and can be made effective.

It has already been said that human nature is individualistic by temperament and people prefer to do things themselves and agree to combine with others only when forced by circumstances to do so. We have also discussed

the causes of combinations and also the factors involved in making combination effective. Over-production and the resultant cut-throat competition are the primary cause of a combination, but this alone is not enough. It is no use combining unless it can be made effective and no combination can be possible so long as foreign producers can easily and freely send goods to our country. After the foreign competition has been shut off or made ineffective, a few more conditions must be fulfilled. The number of producers must be less and the industry should be such that it requires a large amount of capital to start a new business, or the existing business has the monopoly of the raw materials required, leaving little available for the new business. Before the present war there was a keen competition in our textile trade and the duty was not prohibitive enough to prevent imports of cotton goods. If it were possible to stop imports altogether, a combination would not have been possible, the supply from the existing mills not being enough to meet the total demand, and even if the supply were adequate, still the fact that the number of producers was large and scattered all over the country would not make a combination easy or feasible. So long as the producers are not reduced to a manageable number, there can be no combination; and, if one is made, it cannot be effective.

The nature of the cement industry is such that it requires a very large amount of capital to start a new business and seventeen years before there were about a dozen factories spread all over the country. The total capacity of production of these factories together with the imported cement was more than the demand. For this reason all the factories in India suffered then on account of the cut-throat competition and it was about the year 1926 that they

combined and agreed to reduce their output and to sell the products at a certain fixed price. The combination was successful for three reasons:—(1) the number of producers was small, (2) the capital required to start a new cement factory was very large, and (3) the total capacity of production of all the companies was much more than what they were actually producing at that time to meet the demand. There was, therefore, ample room in the existing mills to meet an increased demand. Within the next twelve years or so the consumption of cement in India increased considerably. The building trade itself increased the consumption of cement by at least twentyfive times. Formerly, no cement was used for the roofs of buildings and very little for floors as only the top portion of the floor was coated with cement. Now roofs and floors are of cement concrete. Not only buildings but also roads are now being made of cement concrete on an extensive scale and these have increased the demand for cement considerably. The quality of the Indian product has also improved and is as good as foreign. The Associated Cement Company, Limited, which was formed as a result of amalgamation by twelve cement companies in India from July to November in 1937, was making a good profit and naturally attracted new capital. Dalmia, the famous industrial magnate of Behar, started a cement factory along with several others. He forced the Associated Cement Company, which was reaping a harvest at the cost of the consumers because of their virtual monopoly position, to reduce the price of cement by one rupee per bag of one cwt. Encouraged by the example set by Dalmia two more cement factories have recently been started, one in Assam and the other in the Punjab. The old combination exists but it has practically been made ineffective. Of course, at the present

time the war requirements have considerably increased the demand for cement and there is practically no competition now.

Before the import duty on sugar was levied, the sugar mills all over India were losing heavily on account of the imports of cheap sugar from Java and other foreign countries. The duty completely shut off the foreign sugar from our market except a small quantity of some special qualities of sugar. It was, therefore, a boon to the sugar industry; all the previous losses of the companies were wiped off and large profits were made, which attracted capital, and a large number of factories were started almost immediately. This indiscriminate expansion of the industry and the mushroom growth of a large number of factories, good, bad and indifferent, resulted in over-production and was the cause of loss to many factories. The need of a combination was realised and a weak step was taken to organise a sugar syndicate but, before it could achieve anything, the present war again changed the situation and the mills are now doing well enough. If it were not for this war, time would have shown that such a combination cannot be of much use or bring success as long as the number of producers is so large. After the war when the present artificial demand will be reduced considerably, the sugar mills will have to go through a lengthy process of cut-throat competition which will result in the elimination of some and in the amalgamation of others till a few companies are left. It will then be possible for the remaining companies to form a few large consolidations.

But does this not show that an indiscriminate expansion of companies is harmful to the country and should it not be stopped? The time has come to put some sort of restriction

on this kind of expansion of industries. A similar thing is visible in the expansion of banking in the country at the present time. Allahabad is not an industrial centre, business is not done here on an extensive scale and there has been no expansion in the business activity of the city for the last fifteen years or so, yet the number of banks here has increased from two to fourteen and, if branches are included, the number has gone up from three to seventeen. Dr. L. C. Jain, Professor of Economics in the Punjab University and an ex-President of the Indian Economic Conference, has recently sounded a note of warning against this indiscriminate expansion of banks in India.

In the jute industry India practically enjoys a world monopoly, but there is over-production and the efforts of the jute millowners to combine failed on account of a large number of companies but primarily because of the rivalry between the two groups of producers—Indian and European. In the iron and steel industry the number of producers is very small and among them two are large concerns located side by side, one headed by Tata and the other by Martin & Co. Recently there was a movement for them to combine but they could not agree to the terms. All these factors show that India is not as yet industrially developed enough and, in the large majority of cases, the supply is not more than the demand and in the very few cases where there is over-production, the number of producers is so large as to prevent any combination from being effected. But we are heading towards over-production and the time has already come for us to devise methods to control expansion and to regulate production.

**Conditions in any trade which favour the establishment of a monopoly.**—It is now possible for us to sum up

the conditions under which a monopolistic trust organisation is easily formed. It becomes favourable;

1. ✓ When a company or a group of companies acquires almost the whole of the available raw material needed and a new company can have no easy access to it. This is particularly true of minerals.

2. ✓ When a particular business requires a large fixed capital and involves heavy production expenses. The consequences are that new ventures always find it difficult to get together the necessary capital and to enter into competition with the established firm.

3. ✓ When the number of competing firms is small, for an unwieldy number distributed over a wide area is not easily amenable to consolidation.

4. ✓ When there is little or no foreign competition, or there is an adequate tariff protecting the indigenous industries.

**Trusts in England.**—Conditions in England are unfavourable for trusts. These in the American sense are conspicuously rare in England, though in the general sense of monopolistic combinations, there are some and these are working successfully. But they are more in the nature of German *Kartells*. The position needs some elucidation. Business on a highly concentrated scale is not uncommon in England, but they do not necessarily involve a monopolistic combination. The "Big Five" banks in England furnish a good example. They are a concentrated combination of gigantic financial corporations but do not imply a monopoly of banking business. We find, therefore, from the English example that 'concentration and combination may prepare the ground for monopoly, but do not imply it.'

\* In British textiles, trusts are to be met with, but they



have attained success only where the companies were efficient and prosperous even before they combined. Let us take the examples of two trusts that have been truly successful and the history of their development exhibits certain very interesting traits. The Imperial Tobacco Company of England was "originally a combination of only thirteen companies but it brought about a virtual monopoly in the business. Even before the combination came about, the tobacco industry already had the characteristic features of a highly concentrated combination. The result was that when a rival American Trust sought to intrude upon its monopoly, the Imperial Tobacco Company could resist the attempt with remarkable success. At length the struggle came to an end with a commercial treaty and the British Trust reaped all the advantages due to a victor. Generally speaking, the Trust has worked very well and has been able to escape the popular odium that has fallen to the lot of its American ally, though charges are laid against it that it bullies retailers and tries to choke competition by its bonus scheme.<sup>2</sup>

The other example is that of another British Trust in sewing cotton. This furnishes the most remarkable instance of a successful monopoly. It very much resembles the Standard Oil Company of America in its international character. Like the other, it also grew out of one huge progressive firm. But what is creditable is that J. and P. Coats have never been criticised for the methods they employ, whereas the directors of the Standard Oil Company have earned a bad name in America for their questionable methods and underhand business practices.

**Trusts in America.**—The United States is the home of trusts. There are several industrial and social conditions

<sup>2</sup> Hirst, *The Story of Trusts*, pp. 128-131.

which favoured the growth of huge aggregations of capital there. After the establishment of independence the population of the country increased at an unprecedented rate, immigration influenced it and the marvellous railway development (twenty-three miles in 1830 and 30,000 in 1860) gave a fresh impetus to this expansion.<sup>3</sup> The Government encouraged this expansion of railway lines for military purposes during the Civil War between 1861 and 1865, by granting extraordinarily lavish terms in lands and money to new railway companies. Several of these lines were not economically profitable and in many cases parallel lines were opened, which resulted in cut-throat competition for traffic after the war. The large producers were given favourable rates and, it is said that at times instead of charging freight, the railways paid something extra to the Standard Oil Company for the honour of carrying their oil. The railways charged discriminating rates and it was the small producers who suffered, for the railways discriminated against the small producers both in the order of booking and in the rates charged. The small producers realised that the only way by which they could make their position felt was to expand and to become large; and self-respect and economic necessity demanded this of them. They, therefore, resorted to amalgamation and other forms of consolidation. This consolidation of the smaller business units into a bigger unit made the larger and the privileged corporations feel that, in order to maintain their privileged position, they must not be satisfied with what they are, they should also expand further and become larger still. This rivalry and the privileges of a large corporation encouraged them to form gigantic corpora-

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<sup>3</sup> Hirst, *The Story of Trusts*, p. 55.

tions. Thus large corporations were built on the discriminating railway rates and their rebates. Tariff was another factor in the expansion and the consolidation of business in America. Tariff which was introduced in America about the year 1842 shut out foreign competition and helped the local producers to expand their business. From 1818 to 1833 the American product was protected by heavy duties, which were reduced between 1833 and 1840 and again raised to a high level in 1842. The discovery and exploitation of rich stores of gold, silver, iron, coal and petroleum and the possession by manufacturers of highly valuable patents and possessions helped in the building-up of large monopolistic concerns.

American temperament is another factor and the best brains in the country cared more for business careers than for government service and politics. In England there are certain services which are the exclusive privileges of the aristocracy though this barrier is gradually breaking down. But there was never any aristocratic class in America and, the country being new, prospects in business were great. Ambitious men found that there was a greater scope for wealth, power, position, honour, etc., in business than in politics and government services. They found that big business men could wield very great power all around and even in politics. They, therefore, loved to be at the head of a gigantic corporation to wield this power. It was the industrial magnate, the 'Railroad King' or the 'Oil Dictator,' who dazzled the imagination of the public. Their power was so great that they could easily get their nominee elected to the legislatures and get such laws passed as suited them best. One can easily imagine from one solitary instance the extent of the power which business magnates exercise over

the legislatures and even on the government. The Wool Manufacturers' Association appealed to the Government for an import duty on foreign woollen goods. The Secretary of the Association was appointed Chairman of the Federal Tariff Commission in 1883.<sup>4</sup> This is as good as asking the accused to be his own judge. The result was a foregone conclusion, and in 1884 the completed tariff gave increased protection to woollen manufacturers. Some authors ascribe this to corruption and bribery which, they say, are rampant in American politics and in American society and it is because of this corruption that the business men have succeeded in erecting high tariff walls and with the help of these, to consolidate business organisations.

**Kartells.**—A Kartell is an intermediary form of business combination between loosely-organised alliances and fully developed consolidations or monopolistic combinations. Germany is the real home of Kartells though they are also found in Belgium, France and a few other continental countries.

**Factors which hinder the growth of Trusts in Germany.**—

1. The excellence of the German law prevents the vagaries and excesses of trust finance.
2. The most important railways being under State control, there was no competition among railways, and thus it was not possible for business magnates to build up a monopoly with the aid of discriminations and rebates as was done in America.
3. The sympathetic attitude of the Government towards Kartells has encouraged their formation and maintenance,

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<sup>4</sup> Hirst, *The Story of Trusts*, p. 240.

and, in several cases the Government itself has become member of such unions. -

4. Industrial combinations in Germany are perfectly legal, and price-cutting and boycott are recognised trade weapons. There are laws to prevent unfair competition, but these are chiefly aimed at definite fraud and dishonesty.

The history of German Kartells is interesting and instructive. As in the case of other combinations, over-production and reckless competition also brought them about. The Franco-Prussian War of 1870 was a great step forward in their development. As a result of the war, the Germans obtained a huge indemnity of £200,000,000. This money was utilized in public works of all kinds and the consequent demand led to an expansion in industries. But when this indemnity was exhausted the industrial situation in Germany was faced with a serious problem—the capacity of production was now very much greater than the demand which was no longer so heavy. The German Government now stepped in and afforded some protection to the industries by imposing tariff duties, for the first time, in 1879. Even though the primary motive behind these was revenue, it did help the industries and has since assisted in their maintenance.

When a Kartell is formed, the firms which join send their representatives to form a Central Board or Syndicate. These firms competed with one another at first for selling their products and came together to form a sort of a joint-stock company in order to facilitate the sale of their products and to eliminate the former cut-throat competition. So their aim being limited, their interest is in maintaining as much liberty as is possible in their internal management. The Central Board, therefore, does not interfere in it, but its functions are chiefly to fix the limits of the amount of

production of each unit and to sell it at a reasonable market price. The profits are then proportionately divided. Then again, if any firm does not produce the amount allotted to it, it is given a bonus and similarly, a firm that exceeds the limit is penalized. But care is taken that the bonus does not exceed a certain maximum, so that firms may not have the temptation of sitting idle and 'enjoying a profitable leisure.'

✓ A Kartell, therefore, is a federation organisation, but essentially a partial consolidation. That is so because a number of banks who support and finance the firms have in their hands the reins that control the organisation at the bottom. There lies the secret of the success of the Kartell in Germany and it could never be introduced with profit in the United States of America.

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## CHAPTER X

### SCIENTIFIC MANAGEMENT

People do business for profits. The amount of profit which a man can earn from his business depends upon the amount of capital invested and on his efficiency in selecting the business, its location and men to help him or to work for him in the business. If the business is very small and the man does everything himself, the profit will depend upon his efficiency alone. But, as is usually the case, even in a small business one or more assistants or workmen are engaged, and in a large manufacturing concern thousands of men are employed as labourers, supervisors and departmental heads. All those who work in a business either as employer or as employees contribute to its success and the more the efficiency of all, the greater will the profit be.

A careful analysis of our temperament and nature will show that we are not efficient in all that we do; some work we can do much better than others, and again for some both our aptitude and liking are greater. Students have to study several subjects, but even the best among them does not have the same aptitude and liking for all of them. He feels a greater pleasure in studying a certain subject and can understand and solve its intricate problems more easily, and, after the completion of his general education, if he specialises in that one subject only, the result of his efforts will be better

and more fruitful. If a student has to study three subjects, it may be possible for him to do well in all the three but an inquiry or investigation will disclose that for one of them he has the greatest liking and in it he is at his best. This is true not only of students and their studies, but also of every person, high or low, rich or poor, strong or weak, intelligent or dull. Among the educated classes all are not equally fit to be doctors, lawyers, engineers, university professors, business and technical experts, etc. What an enormous amount of energy is wasted and efficiency lost from the wrong choice of our profession and the selection of our career is more often wrong than right. The criterion is not whether a man is efficient in the line he has selected, but whether he is at his best in it. The sooner we recognise this vital factor, the better for us and for the future generation. This is equally true of the less educated, among the skilled and unskilled workmen whom we call labourers. Among these men also some are better fitted for one type of work and others for another. We often blame our men for their inefficiency but probably the fault lies with the employers themselves. If an intelligent but weak man is engaged to carry heavy loads and another less intelligent but hefty and strong is engaged to tend a delicate machine, both will prove to be inefficient and unsuccessful. This will not be a correct judgment of the ability of the two persons. For their inefficiency they are not so much to be blamed. The fault is more of the employer for selecting the wrong person for the wrong job. It is like trying to fit a square peg in a round hole. These very men will be able to do more and better work if the work given to each is reversed. Lifting and carrying heavy loads require strength and not intelligence, whereas tending a delicate machine requires



intelligence and not strength. Each has a quality which fits him very well for a particular type of work and if he is given that work his productivity considerably increases.

It is thus clear that the establishment of a business and the desire to earn a large profit are not enough to enable a man to earn the maximum. He must organise and manage his business so that the productivity of each man engaged and each machine purchased is at its maximum. It is only then that a man can hope to earn the maximum profit from his business. How to do it is what the science of management teaches us and the new light thrown by Dr. Taylor in devising methods of securing the maximum productivity from each man and each machine is known as "scientific management."

It is clear from what has been said above that if a business man desires the maximum productivity out of each employee, he must give him the work for which he is best fitted or, in other words, men should be so selected that each gets the job for which he is best fitted. This does not mean that if there are ten men best fitted for a job and only eight jobs are available, the other two men should not be engaged for another work in which these two are the best among others. [The principle is that a man should be given a job for which he is best fitted and failing that, the next best.

The selection of men according to their aptitude or liking is not enough. One may have the making of an engineer or a physician or a surgeon but before he can be an expert he must be taught and trained in the science of engineering, medicine or surgery. For the same reason men engaged in a workshop or factory must have been trained

previously or, if necessary, they should be trained in the best methods after being engaged.

If half a dozen best and experienced workmen, all doing the same work, are selected and observations are made of their operations, it will be found that each of them is doing the work in a different way. Certainly all the various methods are not the best and to find which of them is the best a series of experiments has to be made in a separate laboratory in the workshop, with the help of all the six under the guidance of a technical expert. Supposing that a work can be divided into six parts and each is a different process and the technical expert with the help of a stop watch makes the following observations:—(1) each of them takes 12 minutes to complete the job, (2) the time that each takes in completing each portion is different, (3) the minimum time taken by one or the other to complete each part is one and a half minutes. The total time, therefore, to complete the whole job should be nine minutes provided all of them are trained to do each part within the minimum time. It may be possible for the expert to reduce this time further by carefully watching and observing each man working. He may be able to find whether the number of motions taken by each workman for the part which he does in the minimum time can be reduced, and may succeed in eliminating a few unnecessary motions and in improving the method of doing the work and thus reduce further the time required to do it. If the time is reduced to one minute for each part, the whole work can be completed in six minutes in place of twelve and all the workmen may be trained to do the work according to the improved method and within the reduced time.

It may be asked why is it that these six best workmen

take different periods of time to complete each part of the work though all take the same time to complete the whole. The reason is that each workman was trained by different persons none of whom were taught in any standard method of doing the work nor was any effort made to determine one. The usual teachers for these skilled men are their fathers, uncles or brothers. In their childhood they bring food to the factory for their relations and often stay over to watch them working, and in course of time, they are allowed to handle the machine and do the work themselves, and after a reasonable amount of training they are engaged in the junior scale. While in service the father takes care to guide his son to enable him to learn all the intricacies of the trade. After the necessary training thus received he exercises his own intelligence to improve his knowledge. This is the way each man gets his training and develops his craftsmanship. There is no systematically developed and thought-out standard method which they learn. Each develops his own methods and forms his own standard and this is why no workman can claim that his method is the best, for each of the so-called best methods may, as already described, still be subject to improvement. Experience also says that such improvements have been effected in the past. Thus experiments alone can help us to find out the best method of doing a work which may be called the standard method, and also the minimum or the standard time to complete it.

In determining the time required to complete a piece of job one must bear in mind the human factor, *viz.*, our physical limitations. A machine can run continuously for hours so long as it is cleaned and oiled regularly. But this is not possible with men, they cannot work continuously even

if provision is made for food and other necessities of life. In all the physical work that we do, progress depends upon the agility of our limbs which again depends upon the condition of the muscles and the tissues composing them. Continuous work makes our muscles stiff, consequently the agility of our limbs is reduced and the progress in the work is retarded. The muscles require rest to relax the stiffness and to regain the activity of the limbs.

It is then necessary to find out how long the period of rest should be. A longer break than what is necessary does not always make the limbs more active and a shorter rest will not be adequate. Either of the two courses means a loss. It is, therefore, necessary to make a series of experiments with the different periods of rest to determine the actual time for which rest should be given. There is another side to the same question, *viz.*, at what interval the rest should be given. If a man needs rest after every fifteen minutes of work, it will be uneconomical and the productivity will be less if the rest is given after twenty minutes, because the muscles will become stiff after fifteen minutes of work and progress for the next five minutes will be very slow and consequently the total productivity will be less. Similarly, if rests are given at shorter intervals the muscles will not be stiff enough to retard the progress of the work and, therefore, the excess time allowed for rest will be wasted and here too the productivity will be less. It is, therefore, necessary to find out two things: the period of rest and the interval between the two rests. Both these depend upon the nature of the work and they have to be determined separately in each case. If the experiments show that for a particular job the best result would be achieved when a man works continuously

for thirteen minutes and then takes rest for two minutes, for at this rate he will be able to complete thirty-two units per day of eight hours' work, this should be maintained as the standard productivity till a new change for the better has taken place in the method or technique of production. The new standard will then become the standard for the future. It must be clearly understood that whatever may be the standard or the amount of work which every workman should be required to perform every day, the methods of its calculation are such that in no case will a workman feel very much tired at the end of the day's work. According to the system described, sufficient care is taken to prevent any sweating of labour, and at the same time to increase the workman's productivity twice, thrice or even more. At the end of the day or the shift the workman leaves the factory almost as fit as he was when he started. Till the amount of work which each man is capable of doing is found out, the employer is in the dark, he does not know how much each man is capable of doing, and all the time he is suspicious that his workmen are deceiving him, and that they are capable of doing more but actually doing less, and therefore, he is being robbed of his honest money.

(1) The selection of men according to their aptitude and efficiency, (2) the determination of the standard method and the standard time and finally giving the men training in the best methods will not and cannot achieve the object, which is to increase the productivity according to calculation. There is another very important factor on which depends the ultimate success.

The management engages workmen and pays them according to the market rate, in the same way as he purchases raw materials and other commodities. To this extent there

is a similarity between the two and labour is like a commodity bought and sold at the market price. But the similarity ceases here and beyond it the two are very dissimilar. The employer expects every workman to do the full amount of work, in the same way as he expects to obtain the full amount of utility from each article that he purchases, as long as he has the requisite knowledge and the necessary appliances to do it. But this is not so with workmen. The workman almost invariably never produces as much as he is capable of. The employer is aware of it and yet he is helpless. As a matter of fact it would not be quite wrong to say that a workman is not able to increase his productivity even if he wanted, and that he can do so only in certain circumstances. The reason is that the productivity of a man depends upon his efforts, but his efforts depend upon his mental condition, in other words, upon his mood for work. For example, students in the beginning of the session do not much care for their studies, nor can they apply their energy sufficiently and they are also easily persuaded to while away their time. But three months or so before the examination the same students busy themselves in preparation and are not easily persuaded to divert their attention. The reason is that the interest of the students to do well in the examination is very great, hence they are in a mood to study. The desire to pass the examination is so powerful that they require no persuasion or special effort to apply themselves to their studies. We also find that on certain days we can do much better and more work than on other days because on these days we are in a frame of mind and in a mood to do more work and can easily concentrate.

It is thus clear that the productivity of a man depends

very much upon his mood. If the business man wants that the productivity of the men should increase up to a desired level, the workmen must be put in a mood for work and this must be continued to enable him to produce at a continuously increasing rate. In the case of students the desire to do well at the examination puts them in a mood to work hard and from previous experience they know that two or three months' hard work can bring the desired result. But those who are sitting for competitive examinations know that their life will be made or marred by the position they secure. These students naturally work much more than those who are appearing at a university examination. The mood of a man depends upon the amount of impetus. The greater the impetus the harder will a man work and with increasing zeal. This impetus for a workman is the extra wages that he would receive for doing the extra work. When a man is paid wages on the amount of his work, that is, on the number of units that he completes, he has all the incentive, provided the rate of wages is attractive enough, to finish as much or as many units as his abilities will permit him to do.

But there is a limit up to which a man can increase his productivity. The extra wages, therefore, need not be more than a certain amount. How much more the extra wages should be depends upon the nature of work and the amount of extra effort a man has to put in to concentrate his attention to produce to his maximum ability. Experiments have shown that ordinarily 25 to 50 per cent of the daily wages as extra wages or bonus is sufficient to induce a workman to do his best, though in certain types of work and in certain circumstances as high as 100 per cent bonus has to be paid.

The productivity of men, therefore, depends upon four factors:—

1. ✓ To select men according to their aptitude, that is, giving each man a job for which he is best fitted or the next best.
2. ✓ To find out the best or the standard method of doing the work and the minimum or the standard time to complete it.
3. ✓ To provide men with the requisite training to do the work according to the standard method and to complete it within the standard time.
4. ✓ To grant 25 to 50 per cent of the daily wages as bonus or extra wages to those who complete their job within the specified time or do more.

It is thus clear that the well-being of an employer depends upon the well-being of each employee. The well-being of a workman does not mean higher wages only, it also means the development of each man to his state of maximum efficiency, so that he may be able to do, generally speaking, the highest grade of work for which his natural abilities fit him. It further means that he should be given, whenever possible, this class of work to do. It is only then that the workman will be able to produce his maximum and the management will be able to pay him as high wages as he deserves. If this is not done the cost of production will not be reduced to the minimum and in the competition market the increased cost may put the management to a loss, with the result that the production may have to be decreased or even stopped altogether causing thereby unemployment and lower wages for the workmen. The inevitable conclusion is that the prosperity of one depends upon the prosperity of



the other, that the interest of the employer and the employee is the same and not antagonistic, as is commonly believed.

Ordinarily, none of the four principles discussed above are followed even by the best managed concerns. No effort is made by the employer to give men the job for which they are best fitted, or to determine the best method of doing a work and the time required to complete it, and, therefore, the question of training men in the best methods and of paying them extra wages does not arise. The employer expects men to be trained before they are engaged and so employees have to depend for their training on their own resources. It never strikes the employer that the methods of even the best workmen are often defective and open to improvement. These defects tell upon the productivity which decreases and this decrease naturally increases the cost of production, resulting in the lowering of the profits of the employer.


But this is not all; there are other shortcomings, too. We all know that in building a house one must get a complete plan made and arrange for the purchase of a definite number of each article of a particular size, quality and specification and their delivery at the appointed place from time to time as the need arises. Even in a small tailoring house there is a regular plan for making different articles on different dates, and that is how the owner arranges for trial on a particular day and the final delivery on a subsequent day. In the same way a manufacturing concern or a workshop must have a complete plan of its production from day to day. The employer must know at least one day ahead what each man should produce the next day, what articles each machine should produce, what quantity of raw materials should be kept ready. If the same article has to pass

through different machines, its order of progress must be definitely chalked out so that it moves from one machine to another in the proper order. If this is done no man will have to waste his time and no machine will remain idle for want of work.

Ordinarily, in the best managed companies there is a vague plan for the work in hand but there is no detailed, worked-out scheme prepared by the firm in advance for every man and every machine. The assistant superintendent, in charge of the workshop, knows what work is to be done on that day and in the morning when the work begins he divides the work among the foremen and these in turn distribute it among the workmen. It goes without saying that in this arrangement some time is wasted before the workmen can really begin the work and where there are thousands of workmen one can imagine the enormous waste of time and energy. Often the workmen are not supplied with adequate tools. In the absence of any standard shape, size, etc., the repairing of these tools is not done properly and to the satisfaction of the mechanics and the result is that these mechanics have often to go to the smithy, sometimes for adequate reasons and at other times on flimsy grounds, to get the tools repaired according to their requirements. They not only waste their own time and during their absence keep idle the machines they were working upon but also waste the time of the men in the smithy by talking to them. While making experiments to find out the best method of doing a work, experts also make experiments to determine the best shape, size, etc., of the tools required, and the smithy men may be trained in the proper method of repairing them and also supplied with the necessary drawings for the purpose. All this waste can be eliminated by making

for every day's work a complete plan of the whole process of production from the beginning to the end. It is nothing new that the employer would now be required to do, for he did it before also, the difference being that he will now do it more systematically. The work of the production department or of the workshop where articles are manufactured can thus be divided into two parts: the planning and the actual operation or production.

1. **The Planning Department.**—One of the most important functions of the planning department is to see that experiments are made, when new jobs are accepted, to determine the best methods, the time required to complete each unit and to maintain for future reference a proper record of the methods adopted and the time taken. If it is known how long it will take to complete each piece of work, the date of delivery of the new order accepted can easily be determined by adding the number of days it will take to complete it to the number of days necessary for the completion of the existing orders.

When different parts of an article or articles of the same variety are to be made on different machines, it is necessary to lay down the exact route by which each piece of work has to travel in the shop from machine to machine in order that it may be finished at the time needed for assembling. The planning department must have one section responsible for the preparation of a plan of the movement of different articles in the shop and for the issuing of necessary instructions for the men as well as the foremen, indicating the order in which each product must move from place to place till it is complete. One man with a number of assistants may be in charge of this section and he may be called the Order of Work and Route Clerk. 

It is true that workmen are trained in doing a work in the best method and within a certain time, but it is not always possible for them to remember all the methods and the time within which to complete it, nor is it fair to depend upon their memory because there is every chance of losing time thereby. To prevent such waste and losses it is necessary to supply individual workmen with detailed written instructions. This is another section which may be added to the planning department and the person in charge may be called the Instruction Card Clerk.

To prepare and to issue correct instructions, the instruction card clerk may have to refer to a number of files and records and may have to take the help of the order of work clerk. An instruction card is prepared for each workman and foreman. It tells them briefly the drawings to which to refer, the special tools and methods to be used, how to fix the work and the detailed process of completing it, and also the time within which each operation must be finished. It also informs them the number of units to be completed and the bonus to be paid on the completion of the work within the specified time; and further, when necessary, refers them by name to the men who will give them special directions. The instruction card is filled in by one or more members of the planning department, according to the nature and complication of the instructions, and bears the same relation to the planning room as the drawing does to the drafting room. It is important to understand that the workmen do not usually have to read the whole of the instruction. They know the entire process and it is meant to remind them occasionally so that their memory may not fail them and a glance at the card is often enough. At times there may be special instructions which must be read but the workmen do not have to

waste any time in reading them as they can easily do so while the work is in progress. Such time as is necessary to read the instructions is taken into consideration in calculating the amount of work to be completed in a day.

It is always desirable to inform the workmen, without undue delay, the amount of extra wages each has earned from day to day. This acts as an impetus to their future progress. A man is appointed to record the time and the cost of the work and also to prepare the necessary returns. He may be called the Time and Cost Clerk. This is the third section of the planning department.

Whenever a large number of men are working together, differences and disputes do arise between man and man, between foreman and foreman and sometimes between man and foreman. In the interest of a healthy atmosphere, within the shop, the management must be alert not to let these disputes and differences grow and thus impair the efficiency of the men and retard productivity, and must take proper care to maintain discipline in the shop. They should appoint an intelligent and clever man, one who understands human nature well and can command the respect and confidence of a vast majority of the workmen and the foremen, to be responsible for discipline in the shop. He may be called the Shop Disciplinarian. He must take the workmen and the foremen in hand and apply the proper remedy in cases of insubordination and impudence, repeated failure to do their duty, late-coming or unexcused absence. He must see that a complete record of each man's virtues and defects is kept. His attitude should be friendly though firm, and he should play the rôle of a peace-maker.

**2. The Operation or the Production Department.**—In the same way the actual operation in the work-

shop can also be divided into several sections or groups. The person in charge of one section, who may be called the **Gang Boss**, may be responsible for one part of the operation; he should see that the men fix the work in the machine in the proper method and within the specified time. It will also be his duty to help the men working under him to come up to the mark and when necessary he must also show them how to do it within time. Further, he must see that each man has ready by his side all the necessary drawings, tools, materials etc., for the next work, so that there may be no delay in starting it as soon as the piece in hand is finished.

Another person called the **Speed Boss** <sup>✓</sup> may be responsible for guiding and helping the men to complete the work according to instruction and, when necessary, he must demonstrate how to do the work within the specified time by doing it himself, in the presence of his men.

A producer cannot afford to sell defective articles in the market. He, therefore, appoints one or more **Inspectors** to examine the products and to pass only those which are of the standard specification and free from defect. They must be clever men, quick to detect mistakes from a mass of products. Sometimes girls are appointed for this work. A producer making steel balls used in cycles and in other machines for ball-bearing purposes takes particular care not to send to the market a single ball which is in any way defective. It is not physically possible to inspect each and every ball, yet the inspectors are so clever and their eyes are so keen that they can easily spot a defective ball out of a mass. Similar inspectors are appointed also by mints to reject defective coins. In the Calcutta Mint we were once shown how from a mass of coins, the inspector managed to

pick up, within a few seconds, the defective coin which was previously marked and of which the inspector knew nothing. The writer remembers of an incident at the Hazal Atlas Glass Factory, Grafton, W. Va. (U.S.A.), where a whole car-load of Mellin's Food bottles were rejected and remelted on account of a slight defect at the bottom.

A continued working of the machines requires cleaning, oiling and also repairing from time to time. This saves waste and loss, and increases the life of the machines. There should be a man who may be called the Repair Boss and his duty should be to see that each workman keeps his machine clean, and free from rust and scratches, that he oils and treats it properly, and that all of the standards established for the care and maintenance of the machines and their accessories are rigidly carried out, such as care of belts and shifters, cleanliness of floor around machines, and orderly piling and disposition of work.

The work of the planning and the operation departments can each, therefore, be divided into four groups or sections. These are the eight different functions into which the whole operation can be divided. According to the extent of the business and the nature of each of the functions, one man may be in charge of only one section or more, or more than one man may have to be appointed for the same function, of course for different sets of workmen. The underlying idea is that one man is made responsible for one or as few functions as possible, the workman, therefore, will have to take orders from different persons for different functions, and this organisation is then called "functional management," as opposed to the old-fashioned "line organisation," where one person is responsible for all these functions of the men under him.

In a large factory the duties of foremen, gang bosses, etc., are so varied, and call for an amount of special information coupled with such a variety of natural ability, that only men of unusual qualities to start with, who have had years of special training, can perform them in a satisfactory manner.

Under the "line organisation," the foreman is held responsible for the successful running of the entire shop, and when we measure his duties by the standard of the four leading principles of management above referred to, it becomes apparent that in his case these conditions are far from being fulfilled. His duties may be briefly detailed in the following way. He must lay out the work for the whole shop, see that each piece of work goes in the proper order to the right machine, and that the men at the machine know just what is to be done and how to do it. He must see that the work is not slighted and that it is done fast, and all the while he must look ahead a month or so, either to provide more men to do the work or more work for the men to do. He must constantly look to the discipline of the men and re-adjust their wages, and in addition to this, must fix piece-work prices and supervise the time-keeping.

It is best to abandon the line organisation and to divide the entire production work into planning and operation departments and further to subdivide each into sections for functional organisation. The "functional management" or "scientific management," as it is popularly known, not only increases the productivity of each man and machine, but also brings about an intimate co-operation between the management and men and a redistribution of responsibilities.

**Advantages of Scientific Management.**—Employers select men according to their aptitude and give them jobs



for which they are best fitted. This is to the advantage of workmen, both mentally and financially—mentally, because a man feels pleasure, or at least feels it less irksome, to do a work for which he has the greatest aptitude. His productivity is naturally more and he can, therefore, earn more.

Under scientific management a workman is not to think of or worry for his training. The employer takes the responsibility of finding out the best method of doing a work and the time required to complete it. The workman is then trained to do the work according to this method and within the specified time. The productivity of the workman increases thereby and he earns more wages.

To be born with a silver spoon in one's mouth is a phrase usually used for children of rich men, but it can equally be applicable in certain circumstances to children of poor men or men of ordinary means. The children of mechanics and of other skilled workmen get the opportunity of learning the father's trade and qualifying themselves for a better job. It is not true that all these boys turn out to be better mechanics and that children of unskilled workmen, for absence of an opportunity, have to remain unskilled all their lives, though the author has come across several such workmen as would have turned out first-rate skilled men if they had the necessary facilities. Scientific management gives equal opportunities to all and the deserving children of unskilled men can learn the trade to improve their qualifications and to increase their income. Society will also be benefited as the total productivity will increase thereby and the cost of production will be less. The few workmen who have in them the makings of a genius to devise better methods or to discover new machines, etc., would now do

~~it much better and more easily because of the systematic training imparted to them by scientific management.~~

The workman is paid extra wages on completing the work within the specified time. The only disadvantage herein to the workmen is that they do not get the opportunity to while away their time and have to work regularly for the whole period of eight hours or so. This does not mean that the amount of work taken from them is disproportionate to their physical fitness. Nothing of the sort really takes place. There is no sweating of labour. Special care is taken by providing rest at stated intervals to keep them fit during the entire period of work.

Again, neither the employer nor the employee is now ignorant of the amount of work of a particular type, which each workman should do within a certain period of time. Under the old types of organisation this is a source of constant trouble and disagreement.

Finally, there is no more any rivalry between the employer and the employee; they no longer feel that their interests are antagonistic. Scientific management has made them realise that the well-being of one depends upon the well-being of the other and it has given rise to a healthy co-operation between them. This is undoubtedly a great achievement of scientific management.

The only difficulty of scientific management is its <sup>①</sup>cost and <sup>②</sup>the time involved because of the experiments that are to be conducted before it can be introduced in a factory. People do not have the patience to wait for such a long time and many lack the financial resources to meet the initial heavy expense. Still its utility and potentialities have been recognised and necessity being the mother of invention, the

inventive brain of man has devised an intermediary method which is known as "rationalisation."

In passing, it may be mentioned that in India scientific management cannot be introduced so long as education is not made compulsory and the vast majority of our labourers remains uneducated because a knowledge of reading is essential for all workmen before it can be introduced. It is possible, however, to introduce rationalization.

Apart from the advantages of scientific management already discussed, it has made one special contribution, *viz.*, the "spirit of sport," in the field of management. In a game every player must play for the team and not for himself only, that is, he must not indulge in a spectacular show of his skill in the game if it does not help the team to win. It is not the individual player's game alone which can bring victory. There must be perfect co-operation and team-work among the players and then only they can put forth the maximum effort to secure success. Even the best player must realise that the services of each and every player are important and necessary to win a match and, therefore, efforts should be made that each may contribute his maximum, so that the total contribution of all the players put together may be the highest. In the same way in the business field both the employer and the employees must understand that the services of each are to the advantage of the other. The employer must know that in order to obtain the maximum profit, the productivity of each man should be raised to the highest level, which can be possible only by increasing the prosperity of each employee to its maximum. If this is not done the workmen will not be up to the mark and will not be able to contribute his maximum and the profit will, therefore, be less. Similarly, the workman should also

realise that in the prosperity of the employer lies his own prosperity and that the prosperity of the employer can be high only when the productivity of each man is at its highest point. This is what is called the "spirit of sport" in industrial management and when this is achieved, the management is at its best.

Scientific management is often blamed for making workmen automats or machines, things and not thinkers. The point behind this charge is that nature has endowed man with intelligence and reason and because of these man has achieved wonders in the world. When this is so, is it not wrong of scientific management not to utilize this power in workmen? Scientific management, they say, by its subtle devices, absolutely ignores this power in the workmen and tries to convert them into mere machines.

The real grievance against scientific management is that the whole thing is prepared by the management beforehand and the workmen are simply to carry out the work like machines. Men are not required to think how to do it, what tools to use, etc., as usually is the practice with men at a place where there is no scientific management and where men have to use their knowledge and exercise their intelligence and imagination all the time. We all understand and believe that if a man is made to specialise in a job for which he is better fitted, his efficiency will increase and his productivity will be greater. The determination of the best method of doing a work, proper tools to be used etc., cannot be done properly and efficiently by ordinary, clever, skilled men. Only experts can do it and they too require a laboratory to make a number of experiments before they can find out the best methods etc. It is, therefore, clear that even the best workmen cannot do without the help of an expert guide and

a laboratory. This is the reason why the productivity of men is less at a place where there is no scientific management and the result is that the workmen there receive less wages and the management earns less profits. Scientific management is indeed helping men by giving them opportunities to concentrate more on that part of the job for which they are best fitted. This increases their productivity and also their income.

It is true that in the past workmen devised new methods and discovered new machines and today the world is richer thereby. They say that this could be possible only because men were left to themselves and exercised their intelligence and imagination in doing the work. But now as they will not be required to use these faculties, they will not be able to find out or discover anything new and useful. The question is, how many of the workmen have devised something new and in the cases of those few who have, whether their success was due to the fact that they were left to themselves in their daily work. In the last one century or so, only a few workers have devised something useful. For conceiving new ideas, devising new methods and discovering new things, intelligence and reason are not enough. We often find that the best students are not always the best researchers. One must be a genius, or verging on one, to be able to discover something new and useful. Education and training will help men in this work but these alone are not enough. The few workmen who have done something in the past could do so because of the inner urge in them to do something new, and almost in every case, they had to depend upon their meagre resources. Very often the fact that they were left to themselves to think and find out their own methods had nothing to do with their success. As a matter

of fact they were handicapped because their training was not systematic. Scientific management by giving a systematic and proper training prepares the ground for those who have the potentiality of discovering something new. It provides a laboratory for this purpose and anyone showing an aptitude for research is given full opportunities and is paid extra bonus on his success, provided that the new method or device reduces the cost of producing goods for the employer. Scientific management, therefore, instead of retarding progress helps the really deserving men in their genuine pursuits and has rendered a very great service to both the employee and the employer.

## CHAPTER XI

### RATIONALISATION OF INDUSTRY

"This term appears to have first come into common use in Germany in the post-war years of inflation and economic derangement to denote the type of organisation and leadership under which, it was in some quarters contended, German industries must more than ever be arranged in order to stand firm against threatening dissolution." Gradually the term "rationalisation" crept into the terminology of industrial re-organisation.

✓ The term may be used in two senses. In its narrow sense, it refers to the management of the business, and as such, it is akin to, but something less than, scientific management. Its aim is to increase productivity and production is re-organised accordingly. It makes experiments with the help of the best workmen, taking precaution that they do not while away their time, in order to find out how many units one man should be capable of doing. The workmen are required to do the amount of work thus determined and a bonus is paid to those who complete it. The experiments are not, however, directed to find out the best method of doing a work as is done under scientific management. These experiments do not involve a lengthy process, but take a nominal time and are not so expensive. Many factories in England and America have adopted this measure as a substitute for scientific management to increase productivity.

Some of them have devised a method according to which the article to be produced is placed on a slow-moving platform regulated at a definite calculated speed so that its movement does not disturb the men in their work. Those who have seen Charlie Chaplin's 'Modern Times' have formed some idea of what a moving platform is. At Batanagar near Calcutta the Bata Shoe Company has a similar arrangement. Each man has to perform a very small portion of the work and has a limited time within which to complete it; after the specified time the platform moves into the next man's jurisdiction and another shoe comes into his own area to be worked upon. The fear of not completing the job within the time keeps the man alert, prevents waste of time and dispenses with the necessity of supervision. Of course this plan cannot be adopted in every case because it cannot suit every type of work.

In the broad sense, its scope is wider and beyond the production department and, therefore, is more than what scientific management does, because it aims at re-organising the whole concern and effecting improvements all round, so that each aspect and each unit may reach the maximum efficiency and the concern, as a whole, may contribute the maximum productivity and well-being. Now rationalisation has gone a step further to include the industry as a whole. The different concerns carrying on the same trade should combine to get the benefits of a large-scale business, at the same time to stop all internecine conflicts.

A business can yield the benefits of large-scale production up to a certain point beyond which 'decreasing return' begins to operate. The size of a business up to which 'increasing return' is obtainable may be called the 'optimum size' or an 'economic business unit.' There can be no fixed



optimum size of a business, it has to be determined separately in each case as it depends upon many factors, one of them being efficiency of management. Some can manage a large concern with greater efficiency than others. In the same way, several business concerns can combine together but here too there is a limit up to which the combination can yield 'increasing return.'

In the report of the World Economic Conference of 1927 organised by the League of Nations, rationalisation is taken to mean "the methods of technique and organisation designed to secure the minimum waste of either effort or material." It includes the scientific organisation of labour, standardisation of both material and products, simplification of processes, and improvements in the system of transport and marketing.

The real purpose behind rationalisation is prevention of waste and thus it steals a march over scientific management. The waste that it designs to eliminate extends over a vast area—not only in the concern or in the business but in the community and society in general. The methods of rationalisation are equally varied—it seeks to pool everything concerned with the business—the resources, the production and even all business knowledge. By bringing these about, it gets rid of all waste, affords the necessary incentive for everybody to produce his best, thus stimulating the industry from all sides and contributing to the all-round financial prosperity of society.

'Simplification' is another result of rationalisation. The material to be used is always of a standard type and the products that come out are of a standard variety. This entails the suppression of an endless variety of types and also of the needless complexities of the older programme.



When the process is thus simplified and the quality of the product standardised, great advantages accrue to the manufacturer, the retailer and the consumer. The manufacturer can produce more, acquire greater skill, lock up less capital, dispense with the old types of waste and show an increased proficiency everywhere. The retailer need now stock a smaller variety of articles, and this makes his task much easier by doing away with much of his old risks and an additional number of salesmen that a complicated stock of varieties requires. The consumer profits as a result of the cheaper standard products of an improved quality, which means a greater purchasing power for him.

Rationalisation prevents duplication and waste in other directions as well. Advertisement and canvassing naturally become simpler, for producers of identical goods find it to their gain to combine for these purposes. Often different areas are allotted to different producers and an agreed arrangement for transport brings with it all sorts of facilities. Improved grades of articles can, therefore, be marketed and the old needless rivalry gradually disappears.

In the same way, better research facilities can be introduced through rationalisation and with the pooling of scientific, technical and business knowledge, come not only a greater amount of profit for the manufacturer, but also a healthier commercial atmosphere in society.